Institute of
CHARTERED ACCOUNTANTS
of New Zealand

CL 78

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The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Andrea

RE: IASB Exposure Draft of ED 7 *Financial Instruments: Disclosures*

The Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand is pleased to submit its comments on the IASB's Exposure Draft 7 *Financial Instruments: Disclosures* (ED 7). The FRSB sought the views of New Zealand (NZ) constituents on ED 7. Four submissions were received and we have forwarded them to the IASB. Two of these were from New Zealand regulators, one from preparers including one from a bank. The respondents (including the regulators and the bank) opposed the proposals in the Exposure Draft but for different reasons.

In this submission we raise three major concerns arising from ED 7. The first is that we believe that an entity's disclosure of information relating to financial instruments is incomplete without requiring disclosures of its business and other risks. Furthermore, disclosure of business and other risks should form the conceptual basis on which disclosures of financial instruments are based on. The second and third issues relate to our recent experience with promulgating principle based disclosures (we present these in Appendix 1). Our recent experience leads us to believe that minimum disclosures need to be specified and that a separate disclosure standard for financial institutions is necessary.

A Conceptual Approach
ED 7 appears to be a principle based disclosure standard. However, the "principles" are general requirements that rely heavily on the concept of materiality, rather than a conceptual basis for risk disclosures. The disclosure of the risks of financial instruments held by an entity is unlikely to be useful to users of financial statements unless such disclosure is placed within the context of the business and other risk factors that impact the entity. The FRSB recommends that the proposed IFRS should be based on a conceptual approach that specifically requires the identification of the

critical risk factors to the entity. The disclosures proposed in ED 7 should tie into these identified critical risk factors.

ED 7, if promulgated, will be the first major disclosure standard to be issued by the IASB. It would be preferable for such an important milestone document to be based on an appropriate conceptual basis. Given that IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 30 *Disclosures in the Financial Statements of Banks and Financial Institutions* are in-place the FRSB does not see the urgency for this standard.

Specification of Minimum Disclosures

ED 7 leaves significant areas of disclosure to the judgement of the preparers of financial statements and their auditors. In particular, paragraph 8 of ED 7 leaves it to the discretion of the entity to determine what disclosures to make. The FRSB believes that this approach results in a standard that represents guidelines rather than prescribing the minimum level of disclosures.

The FRSB is concerned that the general approach adopted in ED 7 will result in entities providing a minimal level of disclosure. Furthermore, we believe the disclosures made as a result of the proposals in ED 7 may be incomparable. Our comments are based on the FRSB's recent experience, as explained in Appendix 1.

The FRSB recommends that the proposed standard should require minimum disclosures to increase the comparability of financial statements across entities. This is not incompatible with a principles based approach, it merely establishes that there are some disclosure items that the IASB considers are material by nature, regardless of the type of entity.

Disclosures for Banks and Other Financial Institutions

The FRSB notes that banks and other financial institutions have unique risks and, by their nature, can have a considerable impact on the functioning of an economy. For these reasons banks are separately regulated in most jurisdictions. The FRSB appreciates that it would be ideal to have one disclosure standard that is industry-neutral. However, given the unique role and special risks faced by banks and other financial institutions we do not believe that the disclosure requirements proposed in ED 7 are adequate for these entities.

Given the current wording in ED 7, the financial reporting disclosures in ED 7 will not be sufficient for banks and other financial institutions in New Zealand. In developing a standard based on ED 7 the FRSB will therefore have to include additional disclosures to the requirements in ED 7. The FRSB's past experience in developing a standard for banks and financial institutions, as summarised in Appendix 1, leads it to believe that ED 7 as currently worded is insufficient for banks and financial institutions. Appendix 2 includes our recommended additional disclosure requirements for banks and other financial institutions.

The responses to the specific questions raised in ED 7 are on the following pages. If you have any queries, or require clarification of any matters in this submission, please contact me or Joanna Yeoh (Joanna.yeoh@icanz.co.nz).

Yours sincerely

Joanna Perry
Chair – Financial Reporting Standards Board

IASB Question 1

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).*

The FRSB supports the proposed expanded disclosure. However, the FRSB notes that the requirement to disclose the carrying amount of each classification of financial instruments under paragraph 10 is assumed to be the carrying amount net of any impairment loss. The FRSB considers that the net amount is the most relevant disclosure and therefore recommends that ED 7 should clarify that the carrying amount is net of any impairment loss. The FRSB agrees that disclosure of the net amount, together with the disclosure of the amount recognised in the income statement for impairment loss, is appropriate.

The FRSB considers that the balance sheet line item classification of financial assets and financial liabilities should not be replaced by the requirements of ED 7 in paragraph 10. The FRSB notes that in IAS 1 paragraph 68, examples of minimum line items to disclose on the face of the balance sheet are identified. The requirements of ED 7 in paragraph 10 should supplement (as a note disclosure only) the disclosure required in IAS 1 for most types of entities. These disclosure items identified are not specific for banks. IAS 1 previously referred to IAS 30 to identify minimum disclosure for banks (included in IAS 30.19). IAS 30.19 has not been included in ED 7, nor is it included in any standard other than IAS 30. This disclosure is considered necessary in order to disclose the nature of the activities of banks.

The FRSB recommends that the minimum disclosure items for banks need to be retained in addition to the proposed disclosures of ED 7. The FRSB recommends that disclosure about both the nature of activities and the IAS 39 recognition and measurement classifications of financial instruments should be required. The FRSB's recommends the additional requirements that are included in Appendix 2.

The FRSB proposes that there should be a requirement to reconcile the disclosures of the activity-based line items described in IAS 1 with the financial instruments classifications under IAS 39. The FRSB notes that under the current disclosure requirements it is not always apparent what accounting treatment has been adopted for items disclosed on the face of the balance sheet. For example, the disclosure of investments as a line item on the face of the balance sheet does not indicate whether the investments have been measured at fair value through the income statement or through equity. Where an entity has a choice of how to account for financial assets and liabilities, the FRSB considers that an entity should also be required to clearly indicate what accounting recognition and measurement classification it has adopted.

The FRSB proposes that a reconciliation may be a useful way for an entity to reconcile the items disclosed on the face of the balance sheet with the IAS 39 accounting recognition and measurement classification disclosure required by ED 7 paragraph 10. The implementation guidance should provide guidance as to how the information should be disclosed. For example:

Balance Sheet

Cash and balances with the central bank
Treasury Bills and other eligible bills
Trading securities
Loans and advances to other banks
Other money market placements
Loans and advances to customers
Investment securities

Notes

	Cash	Treasury bills	Securities held for dealing	Loans and advances	Money market placements	Investment securities	Total
Financial assets at fair value							
Held-to-maturity							
Loans and receivables							
Available-for-sale							
Total							

Alternatively, this information could be disclosed on the face of the balance sheet:

Balance Sheet

Cash and balances with the central bank at fair value
Treasury Bills and other eligible bills at fair value
Trading securities at fair value through profit and loss
Loans and advances to other banks at amortised cost
Loans and advances to customers at amortised cost
Investment securities
    Available-for-sale
    Held-for-maturity
Liabilities at amortised cost
Liabilities at fair value

The FRSB highlights that paragraph 10(e) has been duplicated. Paragraph 10(e) “financial liabilities measured at amortised cost” should be corrected to read 10(f) to remove the duplication.

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:*

(b) information about any allowance account (see paragraphs 17 and BC14).

The FRSB agrees with the proposed disclosure of any allowance account. The FRSB considers that this disclosure provides useful information to enable the user to assess the adequacy of the allowance for impairment and considers that the disclosure is appropriate for all entities.

The FRSB recommends that the disclosure should be more specific. The FRSB proposes that the IFRS should require a more detailed reconciliation, such as:

- Balance at the beginning of the period
- Additions to impaired assets
- Amounts written off
- Reversals of impaired status
- Balance at the end of the period.

The disclosure requirements should require disclosure of further details on other movements on impaired assets if these movements are material.

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(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).

The FRSB supports the decision to require income statement amounts by classification and specifically agrees with the requirement to disclose how the income statement amount, disclosed by classification, was determined. Additional proposed income statement disclosures for financial institutions are noted in Appendix 2.

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

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(d) fee income and expense (see paragraphs 21(d) and BC17).

The FRSB agrees with the proposed separate disclosure of fee income and expenses.

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

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

The FRSB agrees in principal with the proposed additional disclosure requirements. However, the FRSB recommends that more specific information be provided as discussed above.

The FRSB supports the inclusion of all the disclosure requirements for risk relating to financial instruments in one standard. One constituent recommended that the disclosure requirements of this standard should be reconsidered in the project on small to medium sized entities, as they believe that it would be appropriate to provide exemptions from these disclosure requirements for entities with no public accountability.

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?

The FRSB considers that the proposed disclosure of the fair value of collateral and other credit enhancements is a good initiative. The FRSB agrees that the disclosure of fair value provides more useful information than disclosure of the carrying amount. The FRSB also considers that the proposed disclosure provides information about asset quality.

One constituent did not agree that this disclosure was appropriate on the grounds that full disclosure of this information would be onerous and commercially sensitive. In particular, the constituent highlighted that for banks and other financial institutions preparing quantitative data on collateral would often be impracticable.

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?

The FRSB agrees with the proposed requirement to disclose a sensitivity analysis for exposure to market risk and agrees that this disclosure requirement is a good innovation. The FRSB agrees that ED 7 should not impose specific requirements about the inputs, process and methodology of the sensitivity analysis, as this will not be practical in light of the broad scope of ED 7. However, if no parameters are imposed, the resulting sensitivity analysis will result in disclosure that is not comparable.

The FRSB has highlighted (refer opening comments and Appendix 1) its concern that in the absence of specific disclosure requirements, the resultant disclosures are likely to be less than adequate. The FRSB proposes that additional practical guidance and examples from any field research should be given to illustrate what a sensitivity analysis would look like prepared in accordance with paragraphs 43 and 44. Due to the introduction of new disclosures, any additional guidance will be particularly useful.

One constituent highlighted that disclosure of this nature will require the construction of systems and processes to perform the necessary calculations and this will involve considerable effort. The constituent questions whether the benefit is commensurate with the cost involved for entities other than banks and other financial institutions.

For this reason, the FRSB does not agree with the proposed removal of the requirement previously included in IAS 32 to disclose the earlier of contractual repricing or maturity dates for each class of financial assets and financial liabilities to reflect exposure to interest rate risk. The disclosure of a sensitivity analysis without common parameters does not provide sufficient detail of exposure to risk on its own. The FRSB supports the sensitivity analysis as supplementary disclosure but recommends that the requirement to disclosure the contractual repricing or maturity dates be retained. A repricing table provides disclosure on a consistent basis and therefore is comparable information about entities' exposures to interest rate risk.

A maturity analysis for liquidity purposes may be based on expected maturities, whereas a repricing analysis should always be based on contractual exposures. In addition, it is recommended that additional guidance on how to disclose this information should be included in the implementation guidance, similar to the guidance currently provided by IAS 32 paragraph 74.

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?

Capital is not defined for the purpose of this disclosure. The FRSB agrees that the proposed disclosure on capital is appropriate and adds value for entities when there are externally imposed capital requirements. The FRSB does not propose that ED 7 should define capital for the purposes of this disclosure. The quality of disclosure for entities that do not have externally imposed capital requirements will be undermined because there will be a lack of consistency. Further examples would be useful, particularly in the case of co-operatives and other entities whose members' shares are required to be classified as liabilities in accordance with IAS 32.

One constituent strongly disagrees with the proposal to require disclosure of the internal capital targets and policies for managing capital, as the constituent considers that this information is commercially sensitive.

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?

The FRSB agrees with the proposed effective date and transitional provisions.

One constituent raised a concern regarding the timing of, and the effective date, of ED 7. Where entities are adopting IFRS in 2005, considerable amounts of time and resources will have been invested in order to comply with IAS 32 and IAS 30. The constituent considered that it may be difficult to develop the necessary processes to ensure compliance with the additional, new disclosure requirements. This is particularly relevant to banks, which are subject to the new disclosures under the Basel Accord. The constituent proposed that given the timeframe available and the complexity of the changes, the introduction of the standard should be delayed and the exemption for providing comparatives should be extended.

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?

The FRSB agrees that the disclosure should be part of the financial statements, as the financial statements would be incomplete and potentially misleading without the proposed disclosure.

The FRSB notes that if the disclosure is included in the financial statements, this increases the auditor's responsibility to report on the information that is disclosed. The principles based approach increases the use of judgement by the entity. In addition, the disclosure is flexible in that it stems from internal management reporting structures and information. This may place undue responsibility on the auditor to report on the adequacy of the disclosure that is made.

The FRSB notes that ED 7 paragraph 8 states that an entity decides in light of its circumstances how much detail to provide in order to comply with ED 7. The FRSB emphasises its concern that allowing this degree of flexibility is likely to lead to a lack of consistency in disclosure and an increase in the responsibility of the auditors to ensure that the requirements of ED 7 are complied with.

If the disclosures are not included in the financial statements, they will not be subject to an audit, which would mean that there would be an even further reduced incentive to comply with the spirit of the standard's required disclosure. The FRSB therefore considers that the disclosures required by the draft IFRS should be included in the financial statements.

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 FRSB agrees with the proposed consequential amendments to IFRS 4. We have consulted with our insurance working group (consisting of insurance industry experts) in reaching our conclusion.

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?

The FRSB does not believe that the implementation guidance is sufficient. As noted, we are concerned that the general requirements in ED 7 may result in too little disclosure, especially for financial institutions. In order to highlight a specified minimum disclosure for financial institutions, the FRSB proposes that additional requirements should be included in standard arising from ED 7 or in specifically tailored mandatory application guidance. The expansion of the implementation guidance is recommended in order to increase the comparability of information that is disclosed. In particular the FRSB highlights the following areas where the FRSB believes that additional guidance is required.

Qualitative disclosure

The FRSB supports the requirement to disclose qualitative information but recommends that specific examples should be included to ensure that all relevant disclosures are made. ED 7 paragraph 34(b) requires disclosure of the objectives, policies and processes for managing risk. The FRSB recommends that specific examples should be provided in respect of the policies for managing concentrations of assets, liabilities and off balance sheet items, credit risk including policies with respect to requiring collateral or other security to support credit exposures and the entity's access to that collateral, interest rate risk and currency risk.

Quantitative disclosure

The FRSB notes that ED 7 requires disclosure about concentrations of risk in paragraph 35(c). The proposed implementation guidance accompanying ED 7 then identifies examples of concentrations of credit risk. The FRSB recommends that additional examples of concentrations of risk should be included.

The FRSB recommends including the example of net foreign currency exposures. Current best practice would be to include disclosure of the bank's net open position in each currency.

The FRSB also recommends including the example of risks that stem from concentrations of funding. Such disclosure could be made in terms of customer concentration, industry or economic sector concentrations, geographical funding concentrations or product concentrations.

In the implementation guidance in paragraph 9, sources of credit risk are identified. The FRSB recommends that additional examples of sources of credit risk or guidance could be included in the implementation guidance. An additional example would be the number of individual counterparties and groups of closely related counterparties to which a bank has a credit exposure.

Where customers are identified as a source of risk, the implementation guidance should provide additional guidance for disclosing the method used to identify customer industry sectors. For example customer disclosures may deal with sectors such as governments, public authorities, and commercial and business entities.

The FRSB's proposed additional disclosure requirements are detailed in Appendix 2.

Minimum disclosure on credit risk

The FRSB notes that disclosure of the existence of a legal right to set-off provides useful information about credit risk. For this reason, the FRSB recommends that additional examples included in the current standards could be included in the implementation guidance accompanying the standard arising from ED 7 to illustrate the type of information that is relevant to credit risk. This could include the current guidance included in IAS 32, paragraph 81.

Reference to master netting agreements is found in IG15 (b). The FRSB recommends that additional guidance could be included for disclosure on master netting agreements similar to the current guidance found in IAS 32, paragraph 81.

One constituent proposed that additional guidance should be provided with respect to the disclosure analysis of financial assets that are past due or that are impaired. In relation to the disclosure analysis, it is proposed that the disclosure might differentiate between financial assets which have been assessed as being impaired on an individual basis and those that have been assessed collectively.

Minimum disclosure on liquidity risk

The FRSB highlights the fact that the minimum disclosure on liquidity risk, especially for banks, needs to incorporate assets or there is no relativity and the disclosure on the liabilities alone will not adequately disclose liquidity risks faced.

The FRSB questions why the minimum disclosure included in paragraph 42 requires a maturity analysis for financial liabilities, but not for financial assets. In paragraph 30 of the implementation guidance further guidance is provided to clarify that where an entity manages liquidity risk on the basis of expected maturity dates, then the entity might disclose a maturity analysis of the expected maturity dates of both financial liabilities and financial assets. For a bank, if asset maturity analysis is not disclosed then there is no relativity. Additional emphasis should be placed on the requirement to also disclose maturity dates of assets.

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?

The FRSB agrees that the requirements of ED 7 provide adequate disclosure of fair value and does not propose any additional amendments based on the FASB requirements. The FRSB notes that the requirements of FASB under (a)(iii) above that refer to disclosing the amount of unrealised gains or losses is not required because this is not considered to be a useful additional distinction as a gain or a loss exists regardless of whether it is realised or not.

One constituent noted that IAS 32 (94)(i) previously required the disclosure of the nature of any impairment and the FASB ED requires a description of the 'reason for the remeasurement'. It is proposed that the proposals ED 7 should be expanded to require disclosure of the nature of the loss directly.

Question 10 – Other comments

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

The FRSB supports a principles-based approach that would identify critical risk factors of the entity and provide disclosures about these risks. ED 7, in introducing the disclosures regarding nature and extent of risk arising from financial instruments, needs also to require disclosure of the underlying business risks faced by the entity and how these risks are being managed. This provides greater context to the risk management activity of the entity to the extent that the entity is using financial instruments to manage underlying business risks. Although this is referred to in the implementation guidance, the FRSB believes it would be more appropriate in the body of the standard, to encourage a balanced disclosure of financial risks relative to underlying business risks faced (e.g. where commodity price risk is hedged, or foreign exchange risk is hedged on an anticipatory basis).

The FRSB notes that the concept of materiality should be referred to in paragraph 8 to reduce the level of discretion that is available to the preparers of the information. Where information is material, the entity should be required to make the necessary disclosure. As previously mentioned, the level of judgement allowed by IASB ED could lead to disclosures that are insufficient for users' needs.

There are some disclosures which will be material by nature. Thus even a principles-based approach could specify minimum disclosures. In addition, to avoid any uncertainty where the entity is does not disclose information about a specific risk, a statement regarding why no disclosure is made should be required. For example, if no disclosure is made regarding exposure to credit risk, the entity should state the reason for this is that the entity is not exposed to such risk.

Clarification of what is meant by classes of financial instruments

The FRSB notes that in paragraph 7 of ED 7, an entity is required to make disclosures by class of financial instrument. The FRSB recommends that additional commentary or guidance be provided to define or clarify what classes of financial assets mean.

The current guidance leaves the distinguishing characteristics up to the individual entity. This is likely to lead to non-comparable information. It is also noted, that there may be confusion by preparers and users of financial information between the classes of financial instruments and recognition and measurement classifications of financial instruments as established by IAS 39 and for which balance sheet and income statement disclosure is required.

The following are examples of where additional guidance is required:

1. Paragraph 17 of ED 7 requires disclosure of an allowance account when such an account is used to reduce the carrying amount of financial assets. The FRSB recommends that the disclosure requirements should clarify whether this disclosure is required by the four classification categories identified in IAS 39 in addition to the classes of financial assets identified on the face of the balance sheet. The FRSB recommends that the disclosure requirements should also require disclosure of the impairment loss by the four classifications under IAS 39, as this highlights the exposure of the entity to the categories of credit loss (with the exception of fair value through profit and loss where this is not relevant).

2. Paragraph 26 of ED 7 requires disclosure of the fair value by class of financial assets and financial liabilities identified on the face of the balance sheet. One constituent noted that there might be value in requiring disclosure of the fair value on the same basis as the classifications required under paragraph 10.

3. IAS 30 required specific disclosure of contingencies and commitments including off balance sheet items. The FRSB notes that paragraph 39(a) of ED 7 covers the disclosure of contingent liabilities and commitments that expose an entity to credit risk. However the FRSB recommends that three classes of financial instruments should be specifically identified in the implementation guidance and should be required to be disclosed. These include:

   - direct credit substitutes including general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit. The FRSB notes that the measurement principles of such instruments are covered in IAS 39, but considers that these instruments should be recognised as a separate class of financial instrument and that the maximum exposure for credit risk should be disclosed for this class;

   - short term self-liquidating trade-related contingent liabilities arising from the movement of goods such as documentary credits where the underlying shipment is used as security; and

- other commitments, note issuance facilities and revolving underwriting facilities.

Reclassification

The FRSB agrees with the proposed requirement (paragraph 13) to disclose the reasons for reclassifications from fair value to cost. However, the FRSB recommends that the reason for reclassification should also be disclosed for a reclassification of an asset held at cost to one carried at fair value (for example where a held-to-maturity asset is tainted and is subsequently carried at fair value). In addition to the disclosure of the reason for reclassification, the FRSB recommends that the proposed standard also require disclosure of the amount of the reclassification between fair value and amortised cost and the impact on the carrying value of those financial assets.

Inclusion in standard arising from ED 7 or in the implementation guidance

The FRSB notes that the disclosure requirements in paragraph 12 ED 7 are in the nature of implementation guidance and therefore recommend that this paragraph should be moved to the implementation guidance. It is noted that this paragraph was previously included in the application guidance of IAS 32.

The FRSB notes that in paragraph 34(a) of ED 7 there is a requirement that in relation to each risk arising from financial instruments, an entity shall disclose the exposure to the risk and how it arose. IG 7(a) expands on this to say that the disclosure should describe the entity's exposure to risk and the activities that generated them. The FRSB proposes that IG 7(a) should be incorporated into paragraph 34(a) rather than being in the implementation guidance.

Hedge accounting

The FRSB agrees with the disclosure requirements proposed in paragraph 24 of ED 7 on hedge accounting. The FRSB recommends that the disclosure on hedge accounting should specifically include a paragraph requiring description of the objectives, policies and processes for any hedge activity that is undertaken.

Market risk

Paragraph 43 of ED 7 requires disclosure of a sensitivity analysis for each type of market risk. Paragraph 31 of the implementation guidance lists the various types of market risk, paragraph 40 discusses types of price risk, a sub-category of market risk whilst paragraph 43 discusses additional types of market risk. One constituent noted that the types of market risk for which disclosure is required is not immediately obvious. It is proposed that the definition in Appendix A could be better presented.

Trust and other fiduciary activities

ED 7 requires disclosure in paragraph 21(d) of fee income from trust and other fiduciary activities. The FRSB recommends that additional disclosure should be made where an entity is involved in significant trust activities. The entity should disclose the fact that it is involved in significant trust activities and the extent of the activities. Such disclosure would indicate the entity's potential liability if it fails in its fiduciary duties. For this purpose, the FRSB recommends disclosure of the nature of an entity's involvement in funds management, securitisation, and custodial activities and the nature of these agreements. An entity should disclose the amount of its involvement in funds management and securitisation activities, and where possible its custodial activities.

Appendix 1 New Zealand Regulatory Framework for Banks and Financial Institutions and Recent Experience in Promulgating Principles-Based Disclosures

New Zealand Regulatory Framework for Banks and Financial Institutions

The following illustration highlights the range of regulatory approaches that can be adopted.

Figure 1: Regulatory Environments for Banks (and Financial Institutions)

Lightly regulated	⟷	**Heavily regulated**
♦ Less interventionist ♦ More emphasis on market discipline ♦ Disclosures are very important for the users		♦ Regulators are more interventionist ♦ More importance is placed on the role of the role of the regulator than on market discipline ♦ Less reliance on disclosures

New Zealand is positioned on the extreme left of the above diagram and has been for more than 20 years. In this environment, disclosure requirements for financial institutions are the corner stone of financial reporting, securities regulation and banking supervision regulation. New Zealand is one of the few jurisdictions where disclosure plays a more prominent role than other forms of financial sector regulation. Accounting standard setters, securities and bank regulators have co-ordinated disclosure requirements to ensure the needs of all users of financial statements and other disclosure documents are met while compliance costs on reporting entities are not onerous.

Regulation of financial institutions in New Zealand has developed on the basis that specific, minimum disclosure of financial information required for regulatory purposes has been incorporated into an approved New Zealand Financial Reporting Standard. A major benefit of this approach is the enhancement of the usefulness of financial information disclosures when these are required in the context of the same set of standards that include recognition and measurement of financial information.

The FRSB supports the principle that financial disclosures are best driven by financial reporting standards. This principle recognises that disclosure requirements are more meaningful and easier to interpret when they sit in the context of, and are integrated with, standards on recognition and measurement.

Disclosure requirements for financial institutions are regarded with such importance in New Zealand because the prudential supervision regime is based on the value of self- and market- discipline. Reporting entities themselves are best placed to make appropriate risk/return judgements in the interests of their stakeholders, provided there are disclosure requirements that make the decision making process, including the outcomes of those decisions, transparent. Disclosure requirements, therefore, form the basis of good governance and appropriate financial decision making regardless of the regulatory environment.

Disclosure requirements for financial institutions are particularly important because these entities are highly leveraged, and transact in financial instruments, which are complex and which give rise to significant financial risks. Financial institutions play a central role in financial intermediation and thereby in economic growth and prosperity. As IFRSs are developed for cross-national investments, it can be argued that there is no regulator for trans-national investors and therefore, there should be disclosures that will ensure that investors understand the risks faced by financial institutions.

Recent Experience in Principles-Based Disclosures

New Zealand has had experience in applying a principle-based disclosure standard to all types of entities. In 1994 the Institute of Chartered Accountants of New Zealand issued FRS-31: *Disclosure of Information about Financial Instruments.* Reporting entities found the standard very difficult to comply with because there was no guidance on what was required of the principles. Moreover, given that the scope of the standard covered all entities, reporting entities found it difficult to produce comparable disclosures. The FRSB's experience was that the principle-based approach led to "race to the bottom" disclosures. Reporting entities copied the lowest common dominator disclosures. The lowest common denominator disclosures were particularly problematic in the case of financial institutions.

Users of financial statements needed considerably more rigorous and comparable disclosures than those provided under FRS-31. After several years of grappling with this issue, the Institute of Chartered Accountants of New Zealand established a working group to develop guidance notes for FRS-31. It quickly became apparent that two sets of guidance notes were required – one for corporates and another for financial institutions. Subsequently, the FRSB found that guidance notes did not carry sufficient weight for financial institutions. This was at a time when rigorous disclosure requirements were needed most that is, when risk issues from financial instruments arose. This issue was solved when a separate disclosure standard for financial institutions was developed (FRS-33: *Disclosure of Information by Financial Institutions*). FRS-33 requires more disclosures than IAS 30 *Disclosures in the Financial Statements of Banks and Financial Institutions*.

The FRSB consider that ED 7 is based on a similar approach to that taken in FRS-31. This approach did not result in satisfactory disclosures in New Zealand. Based on its experience with FRS-31 the FRSB does not support implementing ED 7 in New Zealand in its current form.

This experience leads the FRSB to make two recommendations on ED 7. The first is that minimum disclosures need to be specified to achieve comparability. The second is that a separate standard for financial institutions is appropriate.

Appendix 2 Additional Disclosure requirements

This appendix includes the additional disclosure requirements that we recommend should be included in a separate standard specifically for financial institutions.

The FRSB agrees that it is not feasible to satisfactorily define activities such as deposit-taking, lending and securities activities on a global basis, as noted in paragraph BC 7 of ED 7, as the boundaries differ in different jurisdictions. However, the FRSB believes that there is still a need for additional disclosure requirements for banks and other financial institutions. These difficulties could be overcome in each jurisdiction and therefore the FRSB recommends that a possible solution would be to leave the definition of activities to which more rigorous detailed disclosure rules apply to be determined by each jurisdiction, rather than by way of an IFRS. An IFRS is required to identify the required disclosure. The proposed solution would be to adopt an approach similar to that proposed for small to medium sized enterprises whereby the definition of financial activities is left to the individual country to define.

In response to question 1(a)

In addition to the requirements of other Standards, the disclosures in the balance sheet or the notes shall include, but are not limited to, the following assets and liabilities.

Assets

Cash and balances with the central bank

Treasury bills and other bills eligible for rediscounting with the central bank

Government and other securities held for dealing purposes

Placements with, and loans and advances to, other banks

Other money market placements

Loans and advances to customers

Investment securities

Liabilities

Deposits from other banks

Other money market deposits

Amounts owed to other depositors

Certificates of deposits

Promissory notes and other liabilities evidenced by paper

Other borrowed funds

In addition to the classes of financial liabilities disclosed above, a bank should provide information as to the priority of that class of creditors' claims over the bank's assets in a winding up.

In response to question 1(c)

In meeting, and in addition to, paragraph 17, an entity should disclose separately the impairment loss on individual financial assets and groups of financial assets.

Interest income from each class of financial asset (as disclosed in the balance sheet) and from impaired assets should be separately disclosed.

In response to question 3

The FRSB proposes that the contractual repricing disclosure should be retained. If it is retained, guidance should be provided as to how this information should be shown. It is proposed that the guidance would recommend using a tabular form grouped by those that are contracted to mature or be repriced in the following periods after the balance sheet date:

- in one year or less;
- in more than one year but not more than two years;
- in more than two years but not more than three years;
- in more than three years but not more than four years;
- in more than four years but not more than five years; and
- in more than five years.

In response to question 8 – under the heading of quantitative disclosures

In meeting, and in addition to, paragraph 35 of ED 7, an entity should disclose for each class of financial asset and liability, whether recognised or unrecognised, quantitative information about its exposure to currency risk.

Paragraph 9 of the implementation guidance identifies sources of concentrations of credit risk for which disclosure is required under paragraph 35. Additional sources of credit risk are identified below to provide further guidance on what amounts should be disclosed:

1. Customer, industry or economic sector of counterparties.

    - Concentrations of credit risk may arise from exposures to a single debtor or to groups of debtors having such a similar characteristic that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions.
    - Customer disclosures may deal with sectors such as governments, public authorities, and commercial and business entities.
    - The entity should disclose the method used to disclose customer industry sector. For example, one method of disclosing customer industry sectors is to use codes adopted for official statistical reporting purposes.
    - An example of an economic sector that may be separately identifiable includes a manufacturer of equipment for the oil and gas industry that will normally have trade accounts receivable from sales of its products for which the risk of non-payment is affected by economic changes in the oil and gas

industry. A bank that normally lends on an international scale may have many loans outstanding to less developed nations. The bank's ability to recover such loans may be adversely affected by local economic conditions.

2. Geographical distribution: Geographical areas may comprise individual countries, groups of countries or regions within a country. Therefore, where applicable the entity should disclose concentrations of credit exposure by:

    - credit exposure concentrations within the country; and
    - credit exposure concentrations to other countries, showing the amounts of credit exposure to each country.

In accordance with, and in addition to, the requirements of paragraph 35 and 38, it is recommended that disclosure should be required as follows:

1. The number of individual counterparties (not being members of a group of closely related counterparties) and groups of closely related counterparties to which the entity has a credit exposure (net of allowance for impairment loss) which equals or exceeds 10% of equity, in successive ranges of 10% of equity, commencing at 10% of equity.

    For the purposes of this requirement, credit exposures to an individual counterparty or group of closely related counterparties is the amount of the maximum loss that could be incurred under all contracts with that counterparty or group of closely related counterparties in the event of those counterparties failing to discharge their obligations. A group of closely related counterparties is a group of legal or natural persons, one or more of which is a counterparty, who are related in such a way that:

    - the financial soundness of any one of them may materially affect the financial soundness of the other(s);
    - one has the power to control the other(s);or
    - one has the capacity to exercise significant influence over the other(s).

    Counterparty is any other party to a contract with the entity reporting.

2. Branches of overseas incorporated banks shall disclose:

    - whether there are any legal, regulatory or other impediments that restrict the rights of local creditors with respect to their claims over the proceeds of sale of the assets of the global bank and, if so, the nature of those impediments; and
    - that credit exposures to individual counterparties (not being members of a group of closely related counterparties) and to groups of closely related counterparties do not include exposures to those counterparties if they are booked outside that country.

3. An entity must disclose a brief description of any collateral or other similar credit risk support arrangements held in support of its credit exposures.

These sources of concentration of risk should similarly be applied to other risks, including liquidity risk and market risk. Other types of risks for which concentrations of risk should be disclosed where applicable include:

1. Net foreign currency exposures. In meeting, and in addition to ED 7 paragraph 38, a bank should disclose quantitative information about exposure to net foreign exchange exposures. A bank's exposure to currency risk can be measured and disclosed in a number of ways. Best practice would include disclosure of the bank's net open position in each currency, using the local currency value of the net financial assets held in that foreign currency, for both recognised and unrecognised financial instruments. This should enable users of financial statements to compare exposure to currency risk between separate financial reporting periods, and to make comparisons between banks.

2. Concentrations of funding: Disclosure should be made in terms of:

   - customer, industry or economic sector;
   - geographical funding concentrations, showing, where applicable, the following concentrations:
     - concentrations of funding within the country; and
     - concentrations of funding from other countries, showing the amount of funding from each country; and
   - product.