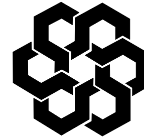

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **IFRS 7 *Financial Instruments: Disclosures***

Subject: **Minor Amendments (Agenda paper 14)**

INTRODUCTION

1. IFRS 7 was issued in 2005 with mandatory application for annual periods beginning on or after 1 January 2007. The objective of the standard is to enable users to evaluate:

   a. the significance of financial instruments for an entity's financial position and performance;

   b. the nature and extent of risks arising from financial instruments; and

   c. how the entity manages those risks.

2. To meet parts (b) and (c) of the objective, IFRS 7 requires both qualitative and quantitative disclosures for each type of risk arising from financial instruments, including minimum levels of disclosure for credit, liquidity, and market risk.

3. For most entities, the adoption of the standard coincided with a period of considerable market disruption. In response to that disruption, the Financial Stability Forum published a report in April 2008 recommending that, among other things, the IASB strengthen its disclosure standards.

4. The Board responded by accelerating its work on disclosures related to off balance sheet risk, fair value measurement and financial instrument risks. The staff prioritised the issues based on discussions held with preparers and auditors of financial statements, users, regulators and others.

5. The Board discussed disclosures related to off balance sheet risk, fair value measurement and liquidity risk disclosures at the September 2008 and October 2008 (additional) Board meetings. The Board issued an Exposure Draft *Improving Disclosures about Financial Instruments* proposing improvements to fair value measurement and liquidity risk disclosures in October 2008 (comment deadline 15 December 2008).

6. This paper addresses other application issues related to IFRS 7 identified to the staff over the past few months. For each issue, this paper:

   a. provides a summary of the disclosure requirement,

   b. discusses how the requirement was applied, including any issues identified, and

   c. provides a staff recommendation on how to address the issue.

7. Although the paper focuses on specific disclosure requirements, the staff note that the following two themes emerged in its review:

   a. the minimum disclosure requirements are burdensome and, in some instances, inconsistent with how an entity manages risk

   b. the qualitative and quantitative disclosures provided by entities are not integrated, and hence users of financial statements often are unable to link related disclosures together to form an overall picture of the nature and extent of risks arising from financial instruments.

8. **Staff recommendation 1:** The staff recommend that the Board insert a sentence after paragraph 32 of the standard stating that the qualitative disclosures in paragraph 33 should support and enhance the quantitative disclosures in paragraphs 34-42.

9. **Question to the Board: Does the Board agree with staff recommendation 1 set out in the preceding paragraph?**

APPLICATION ISSUES

Credit risk disclosures

10. IFRS 7 defines credit risk as “the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.”

11. Paragraphs 36-38 of IFRS 7 set out the minimum quantitative disclosure requirements for credit risk. Application issues have arisen from paragraphs 36(a), 36(d), 37(a), 37(b), 37(c), and 38. Those issues are discussed below.

Paragraph 36(a): Maximum exposure to credit risk

12. Paragraph 36(a) indicates that an entity should disclose its maximum exposure to credit risk for each class of financial instrument at the end of the reporting period. That amount should not take into account any collateral held or other credit enhancements.

13. Although most entities have complied with this requirement, some have questioned its usefulness, stating that:

    a. the requirement results in a large amount being disclosed, which is difficult to explain and not representative of the underlying economic risk because it includes assets with little or no credit risk

    b. the disclosure is superfluous because the amount is apparent from the balance sheet (i.e., the carrying amount represents the maximum exposure for many assets)

    c. it is unclear whether particular types of instruments such as non-derivative assets designated at fair value through profit and loss should be disclosed at their carrying amounts or the amount due.

14. Some have suggested that the requirement either be deleted or clarified to indicate that it only applies to assets for which their maximum exposure to credit loss differs from their carrying amount, including off balance sheet exposures.

15. The staff recommend that the disclosure requirement in paragraph 36(a) be clarified to indicate that it only applies to assets for which their maximum exposure to credit loss differs from their carrying amount. This would include off balance sheet exposures.

16. Such an approach is consistent with the approach taken in paragraph 29(a), which states that disclosure of fair value is not required when the carrying amount is a reasonable approximation of fair value.

17. In the staff's view, requiring an entity to disclose the maximum exposure to credit risk is duplicative, at least in part, for assets that are recorded on the balance sheet. This is because, for those assets, the carrying amount often represents the maximum exposure to credit loss. As such, the staff believe that the disclosure requirement should focus on the entity's exposure to credit risk that is not reflected currently on the balance sheet.

18. **Staff recommendation 2:** For the reasons cited in paragraphs 16-17 above, the staff recommend that the Board clarify that the disclosure requirement in paragraph 36(a) only applies to assets for which their maximum exposure to credit loss differs from their carrying amounts, including off balance sheet exposures.

19. **Question to the Board: Does the Board agree with staff recommendation 2, as set out in the preceding paragraph?**

Paragraph 36(d): Financial assets with renegotiated terms

20. Paragraph 36(d) requires an entity to disclose the carrying amount of financial assets whose terms have been renegotiated to avoid becoming past due or impaired.

21. Entities applied the disclosure requirement in several different ways. Some made no reference to renegotiated financial assets. Others cited continued impairment of the financial assets after renegotiations as support for not disclosing their carrying amounts. Still others disclosed the total amount of renegotiated assets within a given time period.

22. The following application issues were identified in practice and cited as reasons for eliminating the disclosure requirement:

    a. narrowing the disclosure to amounts that would "otherwise be past due or impaired" creates confusion and limits the discussion surrounding renegotiated financial assets

b. it is unclear whether the requirement applies only to financial assets that were renegotiated in the current reporting period or whether prior renegotiations of those assets should be considered

c. the commercial terms of loans are renegotiated regularly for numerous reasons, many of which are unrelated to impairment; it is difficult in practice to ascertain which loans were renegotiated to avoid becoming past due or impaired, especially for a large portfolio of loans where decision making is dispersed.

23. The staff recommend that the disclosure requirement in paragraph 36(d) be deleted.

24. The requirement to disclose only renegotiated financial assets that would otherwise be past due or impaired creates confusion and limits the usefulness of the disclosure.

25. Requiring disclosure of <u>all</u> renegotiated financial assets, without the above limitation, would also be of limited use given that financial assets are renegotiated for numerous reasons other than credit deterioration.

26. Deleting the requirement would allow entities to redirect time and resources towards reporting and explaining information used internally to manage credit risk.

27. If the Board decides to retain the disclosure requirement, the staff recommend that the Board modify it to require the disclosure of financial assets whose terms have been renegotiated in the reporting period due to the credit deterioration of those assets.

28. **Staff recommendation 3:** Given the confusion created by this requirement and the difficulty in identifying financial assets whose terms have been renegotiated to avoid becoming past due or impaired (rather than for other commercial reasons), the staff recommend that the disclosure requirement in paragraph 36(d) be deleted.

29. **Question to the Board: Does the Board agree with staff recommendation 3, as set out in the preceding paragraph?**

Paragraph 37(a): Ageing analysis

30. Paragraph 37(a) requires an entity to disclose, for each class of financial asset, an ageing analysis for financial assets that are past due at the reporting date but not impaired.

31. IFRS 7 indicates that a financial asset is past due when a counterparty has failed to make a payment when contractually due.

32. Although most entities have complied with this requirement, some have questioned its usefulness, stating that:

    a. the requirement does not represent the commercial substance of many arrangements (i.e., missing a single interest payment by one day should not cause the entire loan balance to be past due)

    b. trading portfolios and available-for-sale financial assets should be exempt from the requirement because their carrying amounts reflect their credit status.

33. Those entities suggested that the Board modify the definition of *past due* such that payment within a commercially accepted interval (e.g., 30 days after the contractual due date) would not cause the financial asset to be deemed past due. They noted that such an approach is consistent with the ageing analyses that banks prepare for management reporting purposes.

34. The staff recommend that the definition of past due and the disclosure requirement in paragraph 37(a) remain unchanged.

35. Although the definition of past due in IFRS 7 may seem rigid when compared to internal management reporting, entities are encouraged to disclose their methods used to measure credit risk. This would allow entities to explain any differences between internal reporting and the ageing analysis described in paragraph 37(a).

36. The Board explained its rationale for including an ageing analysis in the Basis for Conclusions, stating that the analysis assists users in identifying financial assets that are more likely to become impaired and helps them estimate the level of future impairment losses. In the Board's view, the ageing analysis is a leading indicator of impairment loss.

37. Providing information about <u>all</u> financial assets with payments that are past due (but not impaired) allows users to make judgements about the likelihood of future

impairment losses. Those judgements will be affected, in large part, by the age of the past due payment and related disclosures about how the entity manages past due assets.

38. Furthermore, the standard allows entities to select the time bands for their ageing analyses, enabling them to present the data in a manner that readily reconciles with internal reporting.

39. **Staff recommendation 4:** For the reasons cited in paragraphs 35-38 above, the staff recommend that the definition of past due and the disclosure requirement in paragraph 37(a) remain unchanged.

40. **Question to the Board: Does the Board agree with staff recommendation 4, as set out in the preceding paragraph?**

Paragraph 37(b): Individually impaired financial assets

41. Paragraph 37(b) requires an entity to disclose, for each class of financial asset, an analysis of financial assets that are individually determined to be impaired at the reporting date, including the factors considered in the impairment analysis.

42. In practice, most entities provided quantitative data on individually impaired financial assets, typically in tabular form, with little supporting commentary.

43. The most frequently cited practice issue related to the impairment of portfolios of financial assets on a collective basis.

44. IAS 39 indicates that financial assets that are not individually significant may be aggregated with financial assets with similar credit risk characteristics for impairment purposes. This is often the case for financial assets included in trade and other receivables.

45. The issue is whether financial assets that are assessed for impairment collectively should be included in the paragraph 37(b) disclosure or whether those assets fall within the scope of another paragraph.

46. Some believe that financial assets assessed for impairment collectively are subject to either paragraph 36(c) or paragraph 37(a) because paragraph 37(b) only contemplates financial assets that are individually determined to be impaired. Paragraph 36(c) addresses financial assets that are neither past due nor impaired. Paragraph 37(a) addresses financial assets that are past due but not impaired.

47. The staff recommend that the Board add a new disclosure requiring an entity to disclose an analysis of financial assets that are collectively assessed for impairment at the end of the reporting period, including the factors considered in determining whether they are impaired.

48. In the staff's view, the existing disclosure requirements in paragraphs 36(c), 37(a) and 37(b) do not address financial assets assessed for impairment collectively for the following reasons:

    a. It is likely some of the financial assets within the pool are past due but not impaired,

    b. It is likely that some of the financial assets within the pool are not past due, and

    c. The financial assets are not individually determined to be impaired.

    As such, requiring an entity to disclose financial assets that are collectively assessed for impairment in paragraphs 36(c), 37(a) or 37(b) would likely misrepresent the information captured in those respective disclosures.

49. **Staff recommendation 5:** For the reasons cited in paragraph 48 above, the staff recommend that the Board add a new disclosure requirement for financial assets that are collectively assessed for impairment.

50. **Question to the Board: Does the Board agree with staff recommendation 5, as set out in the preceding paragraph?**

Paragraph 37(c): Fair value of collateral and other credit enhancements

51. Paragraph 37(c) requires entities to disclose, for each class of financial asset, a description of collateral and other credit enhancements held as security for financial assets that are past due but not impaired and financial assets individually determined to be impaired at the reporting date.

52. Entities are also required to disclose the fair value of those credit enhancements, unless impracticable.

53. The requirement yielded inconsistent results in practice, with many entities choosing not to disclose the fair value of collateral held (presumably because it was impracticable to do so).

54. Some have questioned the usefulness of the requirement, stating that:

   a. the disclosure of aggregate fair value by class of financial asset is not meaningful because it does not reveal the extent of over- or under-collateralisation

   b. it is difficult to estimate the fair value of credit enhancements for particular types of financial assets such as commercial mortgage loans, which often include multiple forms of enhancements.

55. Some have suggested that the Board remove the requirement altogether or, at a minimum, modify the disclosure to require entities to disclose the extent of over- or under-collateralisation for each class of financial asset.

56. Those in favour of removing the requirement note that the effect of the credit enhancements is already reflected in the carrying amount of the financial assets.

57. The staff recommend that the Board modify paragraph 37(c) to require entities to disclose the extent of over- or under-collateralisation for each class of financial asset, unless impracticable. That disclosure would only apply to financial assets that are past due but not impaired and financial assets individually determined to be impaired at the reporting date.

58. Under the recommended approach, entities would not be required to disclose the aggregate fair value of credit enhancements held.

59. The staff believe the recommended approach would provide more useful disclosure because it would highlight the extent to which entities are exposed to credit risk for each class of financial asset rather than an aggregate (and hence meaningless) number.

60. **Staff recommendation 6:** For the reason cited in paragraph 59 above, the staff recommend that the Board modify paragraph 37(c) to require entities to disclose the extent of over- or under-collateralisation for each class of financial asset, unless impracticable.

61. **Question to the Board: Does the Board agree with staff recommendation 6, as set out in the preceding paragraph?**

Paragraph 38: Foreclosed collateral

62. For entities that foreclose on collateral or call on other credit enhancements during the reporting period, paragraph 38 requires disclosure of:

a. the nature and carrying amount of the assets obtained; and

b. the entity's policy for disposing of such assets (or using them) when not readily convertible to cash.

63. In practice, entities provided little to no disclosure about foreclosed collateral. One entity indicated that the amount was immaterial. Another entity noted that banks rarely take possession of the underlying collateral.

64. The most frequently cited practice issue related to whether entities are required to disclose the nature and amount of foreclosed collateral held at the reporting date or the nature and amount all foreclosed collateral obtained during the reporting period.

65. The staff recommend that the Board clarify that entities need only disclose the amount of foreclosed collateral held at the reporting date.

66. Such an approach is consistent with the standard's objective of disclosing information to enable users to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed *at the end of the reporting period*.

67. **Staff recommendation 7:** To eliminate confusion about the Board's intent for this disclosure requirement, the staff recommend that the Board clarify that entities need only disclose the amount of foreclosed collateral held at the reporting date

68. **Question to the Board: Does the Board agree with staff recommendation 7, as set out in the preceding paragraph?**

Market risk disclosures

69. IFRS 7 defines market risk as "the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk."

70. Paragraphs 40-42 of IFRS 7 set out the minimum quantitative disclosure requirements for market risk. Application issues have arisen from paragraphs 40(a) and 41. Those issues are discussed below.

Paragraph 40(a): Impact on profit or loss and equity

71. Paragraph 40(a) requires entities to disclose a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable.

72. One entity observed that this requirement focuses exclusively on accounting sensitivity, excluding market risk sensitivities that do not directly impact profit and loss or equity (e.g., interest rate risk arising on fixed rate financial assets held at amortised cost).

73. The same is not true of the value-at-risk approach in paragraph 41, which contemplates changes in economic value.

74. The issue is whether the sensitivity analysis in paragraph 40(a) should be limited to market risks that affect profit and loss or equity.

75. The staff recommend that the Board state in the Implementation Guidance that entities are encouraged to discuss the effect of changes in the relevant risk variable on economic value not manifest in profit and loss or equity.

76. Encouraging, but not requiring, a separate analysis of the effect on economic value is consistent with the Board's rationale for not requiring entities that employ value-at-risk to disclose the effects of that approach on profit and loss or equity.

77. In the Basis for Conclusions, the Board stated that its objective was to require disclosures about sensitivity, not to mandate a particular form of sensitivity disclosure.

78. **Staff recommendation 8:** For the reasons cited in paragraphs 76-77 above, the staff recommend that the Board state in the Implementation Guidance that entities are encouraged to discuss the effect of changes in the relevant risk variable on economic value not manifest in profit and loss or equity.

79. **Question to the Board: Does the Board agree with staff recommendation 8, as set out in the preceding paragraph?**

Paragraph 41: Stress testing

80. Paragraph 41 indicates that entities may use a sensitivity analysis that reflects interdependencies between risk variables, such as value-at-risk, in lieu of the analysis specified in paragraph 40.

81. Most entities did not provide quantitative data related to losses that would be experienced in stress conditions because such an analysis is not required by IFRS 7.

82. One entity observed that the disclosure of potential losses due to stress conditions would arguably be of greater use than the disclosure requirements for value-at-risk, a methodology that does not contemplate extraordinary market movements. The entity further observed that Basel II Pillar 3 will require banks to disclose the details of their stress testing beginning next year.

83. The issue is whether IFRS 7 should require disclosure of losses that would be experienced in stress conditions for all entities.

84. The staff recommend that the Board not require minimum quantitative disclosure related to stress testing.

85. This is consistent with the requirement in paragraph 40(a) to show the effect of *reasonably possible* changes of the relevant risk variable. The Application Guidance notes that a reasonably possible change should <u>not</u> include stress tests. The Basis for Conclusions further notes that a reasonably possible change is judged relative to the economic environment in which the entity operates, and does not include 'worst case' scenarios.

86. However, the staff note that given recent market conditions, an entity's assessment of what constitutes *reasonably possible* changes should be reassessed.

87. **Staff recommendation 9:** For the reasons cited in paragraphs 85-86 above, the staff recommend that the Board not require minimum quantitative disclosure related to stress testing.

88. **Question to the Board: Does the Board agree with staff recommendation 9, as set out in the preceding paragraph?**

Other issues

89. In addition to the above issues surrounding the disclosure of credit and market risk, several other issues have arisen in practice. Those issues relate to paragraphs 15 and 34(b) of the Standard. Each of these paragraphs are discussed below.

Paragraph 15: Selling or repledging of collateral

90. For entities that hold collateral, whether financial or non-financial assets, and are permitted to sell or repledge the collateral, paragraph 15 requires disclosure of:

    a. the fair value of collateral held;

    b. the fair value of collateral sold or repledged and whether the entity has an obligation to return it; and

    c. the terms and conditions associated with its use of the collateral.

91. Some entities have questioned the usefulness of this requirement and requested that it be removed.

92. The staff understand that this disclosure was previously in paragraph 94(c) of IAS 32 and was moved into IFRS 7 without reconsideration.

93. The staff recommend that the requirement be retained. The staff agree with the Board's conclusion in the Basis for Conclusions that it is reasonable to expect an entity to know the fair value of collateral that it holds and can sell.

94. The staff note that US Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, includes a similar disclosure requirement.

95. In support of the requirement, paragraph 320 of FAS 140 states that the FASB considered that information relevant for investors and creditors who wish to understand the scale of collateralised transactions, the extent to which that collateral is used, or the relationship between income from use of collateral and the amount of collateral used and available for use.

96. In considering the costs of preparing that information, the FASB determined that similar information is already maintained for other purposes by entities that accept large amounts of collateral.

97. **Staff recommendation 10:** For the reasons cited in paragraphs 93-96 above, the staff recommend that the disclosure requirement in paragraph 15 be retained.

98. **Question to the Board: Does the Board agree with staff recommendation 10, as set out in the preceding paragraph?**

Paragraph 34(b): Materiality

99. To the extent not otherwise disclosed, paragraph 34(b) requires entities to disclose the information required by paragraphs 36-42 related to credit, liquidity, and market risk unless the risk is not material.

100. Some entities requested that the Board remove the reference to materiality in paragraph 34(b) because it could be read to imply that other disclosures in the standard are required even if not material.

101. The staff agree with that assessment and recommend that the reference to materiality be removed.

102. **Staff recommendation 11:** To avoid confusion about the Board's intent, the staff recommend that the Board remove the reference to materiality in paragraph 34(b) of the standard.

103. **Question to the Board: Does the Board agree with staff recommendation 11, as set out in the preceding paragraph?**

SUMMARY OF STAFF RECOMMENDATIONS AND PROPOSED AMENDMENTS TO IFRS 7

104. The following chart summarises the staff's recommendations on how to address the application issues related to IFRS 7.

CREDIT RISK DISCLOSURES		
Paragraph	**Description**	**Staff recommendation**
36(a)	Maximum exposure to credit risk	Clarify that disclosure only applies to assets for which their maximum exposure to credit loss differs from their carrying amounts
36(d)	Financial assets with renegotiated terms	Remove
37(a)	Ageing analysis	Remain unchanged
37(b)	Individually impaired financial assets	Add a new disclosure requiring an entity to disclose an analysis of financial assets that are collectively assessed for impairment at the end of the reporting period
37(c)	FV of collateral and other credit enhancements	Require disclosure of over- and under-collateralisation
38	Foreclosed collateral	Clarify that need only disclose amount held at reporting date
MARKET RISK DISCLOSURES		
Paragraph	**Description**	**Recommendation**
40(a)	Impact on profit or loss and equity	State in Implementation Guidance that encouraged to discuss effect of analysis on economic value
41	Stress testing	No requirement needed
OTHER ISSUES		
Paragraph	**Description**	**Recommendation**
15	Selling or repledging collateral	Remain unchanged
32	Qualitative and quantitative disclosure	Insert sentence stating that qualitative should support quantitative disclosure
34(b)	Materiality	Remove reference to materiality

105. The staff recommend that the Board address these issues as part of its Annual Improvements project because the proposed clarifications are not urgent but would require an amendment to IFRS 7.

QUESTION FOR THE BOARD

106. The staff recommend that the clarifications be included as part of the Annual Improvements project. Does the Board agree with this recommendation? If not, what would the Board like to do, and why?