IFRIC Meeting Agenda reference **19**

Staff Paper Date **January 2010**

Project	**Annual Improvement Project – 2008-2010 cycle - Comment letter analysis**
Topic	**IFRS 7 *Financial Instruments: Disclosures* – Disclosures about the nature and extent of risks arising from financial instruments**

Introduction

1. In the *Annual Improvements* exposure draft published in August 2009, the Board addressed an issue relating to disclosures about the nature and extent of risks arising from financial instruments.

2. This issue arose from a report published by the Financial Stability Forum in April 2008 recommending that the IASB strengthen its disclosures standards.

3. The objective of this paper is:

   (a) To provide background information on the issue,

   (b) To analyse the comment letters we received, and

   (c) To recommend the IFRIC amend the wording from the exposure draft as proposed in Appendices A and B.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

Background

4. This issue was discussed at the IASB Board meeting in December 2008, and the issue was set out in agenda paper reference 14 and can be found on the public website[1].

5. The Board proposed an amendment to IFRS 7 that:

   (a) states that the qualitative disclosures in paragraph 33 should support and enhance the quantitative disclosures in paragraphs 34–42. The Board concluded that an explicit emphasis on the interaction between qualitative and quantitative disclosures will contribute to disclosure of information in a way that better enables users to evaluate an entity's exposure,

   (b) removes the reference to materiality from paragraph 34(b). The Board noted that the reference could imply that disclosures in IFRS 7 are required even if those disclosures are not material, which was not the Board's intention,

   (c) clarifies that the requirement in paragraph 36(a) applies to financial assets whose carrying amounts do not reflect the reporting entity's maximum exposure to credit risk and off balance sheet exposures. In the Board's view, the disclosure requirement should focus on the entity's exposure to credit risk that is not already reflected in the statement of financial position,

   (d) requires disclosure of the financial effect of collateral held as security and other credit enhancements in paragraph 36(b), and removes the requirement in paragraph 37(c) related to collateral held as security or other credit enhancements. The Board considered that within a class of assets some might be over-collateralised while others might be under-collateralised. Hence, aggregate disclosure of the fair value might be

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[1] http://www.iasb.org/Meetings/IASB+Board+Meeting+18+December+2008.htm

misleading. However, the Board believes that information on the financial effect of such assets is useful to users.

(e) removes the requirement in paragraph 36(d) related to financial instruments renegotiated to avoid becoming past due or impaired. In practice it is difficult, especially for a large portfolio of loans, to ascertain which loans were renegotiated to avoid becoming past due or impaired. Hence, the Board proposed to delete the disclosure requirement in paragraph 36(d); and

(f) clarifies that the requirement in paragraph 38 applies only to foreclosed collateral held at the reporting date. The Board noted that this is consistent with the objective in IFRS 7 to disclose information that enables 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.

Analysis of comments received

6. The Board received 70 comment letters on the 2009 Annual Improvements of which 58 commented on the subject of this paper.

7. The comment letters breakdown as follows:

Yes:	24
Yes, but expressed comments:	24
No:	10
Total:	58

Staff analysis in response to the comments raised

Qualitative and quantitative disclosures – paragraphs 33-35

8. Some constituents[2] point out that the wording used in proposed paragraph 33A suggests that paragraph 33 is subordinate to the quantitative disclosures set out in paragraph 34. They believe, rather, that the quantitative disclosures support the qualitative ones.

9. The staff agrees to clarify in the standard the objective of linking both types of disclosures. The staff doesn't necessarily agree that qualitative or quantitative should be subordinate to one another. The staff therefore suggests paragraph 33A be replaced with a paragraph 35A after the requirements on qualitative and quantitative disclosures to put the emphasis on the interaction between both types of disclosures. The objective is for users of financial statements to be able to link related disclosures together to form an overall picture of the nature and extent of risks arising from financial instruments.

10. Other constituents[3] are concerned that removing the reference to materiality may be interpreted in some jurisdictions to require disclosure even for non material items.

11. The staff points out that the concept of materiality is discussed in paragraphs 29 and 30 of the *Framework* and in paragraph 31 of IAS 1 *Presentation of Financial Statements.* Requirements related to materiality therefore apply to all transactions throughout the standards. As a consequence it does not need to be repeated in each standard.

[2] KPMG CL 52
[3] BDO CL 53, BusinessEurope CL 13

Exposure to credit risk and financial effect of collateral - paragraph 36(a) and (b)

12. Some constituents[4] are concerned that the proposed requirement in paragraph 36(a) of IFRS 7 results in the information being spread across the notes to the financial statements. They believe this impairs clarity.

13. They are also concerned that paragraph 36(b) would require disclosure of the financial effect of collateral for certain instruments for which the exposure to credit risk which is being mitigated would not be disclosed due to the change in paragraph 36(a).

14. They thus believe that the requirements in paragraphs 36(a) and (b) should be combined. They suggest the use of a tabular format showing per class of assets the carrying amount, the maximum exposure to credit risk and the financial effect of collateral.

15. The staff notes that a majority of respondents however agree with the proposed changes that aims at removing unduly burdensome disclosures. As stated in the Basis for Conclusions to the proposed amendment, requiring an entity to disclose the maximum exposure to credit risk might be duplicative for assets that are recorded on the balance sheet. For these assets, the carrying amount often represents the maximum exposure to credit loss. Therefore the staff believes no changes should be made to the proposed amendment on paragraph 36(a).

16. Other constituents[5] ask for a clarification of "financial effect" used in paragraph 36(b) as this is not a term already defined in IFRSs. They question whether the intent of the Board is to require quantitative or qualitative information. They believe that qualitative information is already required in paragraph 33.

17. The staff acknowledges that the intent in paragraph 36(b) is to require both qualitative and quantitative disclosures. In addition, with paragraph 37(c) being removed (disclosure of the aggregate fair value of collateral and other credit

[4] Accounting Standard Board CL 2, Grant Thornton CL 26, DTT CL 23
[5] EY CL 47, KPMG CL 52

enhancements), the Board decided it is useful to disclose quantitatively the effect on the financial statements of over or under-collateralisation. The staff believes that the proposed amendment reflects the intent of the Board and doesn't propose any changes.

Staff recommendation

18. The staff recommends the proposed amendment be modified as set out in Appendix A to remove paragraph 33A and add a paragraph 35A to stress the interaction between qualitative and quantitative disclosures that contributes to disclosure of information in a way that better enables users to evaluate an entity's exposure.

Questions to the IFRIC

Question 1 – Proposed changes
Does the IFRIC agree with the staff recommendation in paragraph 18 for the reasons set out in paragraphs 8 to 17?

Question 2 – Proposed wording
Does the IFRIC agree with the proposed changes set out in Appendices A and B? If not, what wording would the IFRIC suggest?

Appendix A – Proposed drafting of final amendment

A1. This appendix includes the proposed drafting of the final amendment. It is based on the text included in the Bound Volume as of 1 January 2009. New text is underlined and deleted text is struck through.

Amendment to IFRS 7 *Financial Instruments: Disclosures*

Paragraph 35A is added. Paragraphs 34 and 36–38 are amended. Paragraphs 33 and 35 are not proposed for amendment, but are included for ease of reference. Paragraph 44I is added.

Qualitative disclosures

33 For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

34 For each type of risk arising from financial instruments, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in accordance with (a)~~, unless the risk is not material (see paragraphs 29–31 of IAS 1 for a discussion of materiality)~~.

(c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

35 If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

35A Providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The interaction between qualitative and quantitative disclosures contributes to disclosure of information in a way that better enables users to evaluate an entity's exposure.

Credit risk

36 An entity shall disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with IAS 32); this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.~~;~~

(b) ~~in respect of the amount disclosed in (a),~~ a description and the financial effect of collateral held as security and other credit enhancements (eg a description of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument).~~;~~

(c) information about the credit quality of financial assets that are neither *past due* nor impaired.~~; and~~

(d) [deleted] ~~the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.~~

37 An entity shall disclose by class of financial asset:

(a) an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and

(b) an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.~~; and~~

(c) [deleted] ~~for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.~~

Collateral and other credit enhancements obtained

38 When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose for such assets held at reporting date:

(a) the nature and carrying amount of the assets ~~obtained~~; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Effective date and transition

44I *Improvements to IFRSs* issued in April 2010 added paragraph 35A and amended paragraphs 34 and 36–38. An entity shall apply the amendment for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on proposed amendment to IFRS 7 *Financial Instruments: Disclosures*

This Basis for Conclusions accompanies, but is not part of, the amendments.

Paragraph BC47A is added. A header after paragraph BC47A and paragraph BC47B are added.

Paragraphs BC49A is added. A header after paragraph BC54 and paragraphs BC54A are added.

Paragraphs BC55A and BC56A are added.

BC47A As part of the *Annual Improvements* 2008-2010 cycle, the Board decided to remove the reference to materiality in paragraph 34(b) of IFRS 7. The Board noted that the reference could imply that disclosures in IFRS 7 are required even if those disclosures are not material, which was not the Board's intention.

Interaction between qualitative and quantitative disclosures

BC47B As part of the *Annual Improvements* 2008-2010 cycle, the Board decided to emphasise the interaction between qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments. The Board noted that providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The Board concluded that an explicit emphasis on the interaction between qualitative and quantitative disclosures will contribute to disclosure of information in a way that better enables users to evaluate an entity's exposure.

Credit risk (paragraphs 36–38, B9 and B10)

Maximum exposure to credit risk (paragraphs 36(a), B9 and B10)

BC49A As part of the *Annual Improvements* 2008-2010 cycle, the Board decided to clarify that the disclosure requirement in paragraph 36(a) applies only to financial assets whose carrying amounts do not show the reporting entity's maximum exposure to credit risk. The Board noted that 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. Moreover, the Board concluded that the requirement might be duplicative for assets that are presented in the statement of financial position because the carrying amount of these assets often represents the maximum exposure to credit risk. In the Board's view, the disclosure requirement should focus on the entity's exposure to credit risk that is not already reflected in the statement of financial position.

Financial assets with renegotiated terms

BC54A As part of the *Annual Improvements* 2008-2010 cycle, the Board decided to delete the requirement in paragraph 36(d) to disclose the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated. The Board considered 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 Board noted that the current requirement was unclear about whether the requirement applies only to financial assets that were renegotiated in the current reporting period or whether past negotiations of those assets should be considered. Moreover, the Board was informed that commercial terms of loans are often renegotiated regularly for reasons that are not related to impairment. In practice it is difficult, especially for a large portfolio of loans, to ascertain which loans were renegotiated to avoid becoming past due or impaired.

Financial assets that are either past due or impaired (paragraph 37)

BC55A As part of the *Annual Improvements* 2008-2010 cycle, the Board considered the usefulness of disclosure of the fair value of collateral and other credit enhancements required in paragraph 37(c). The Board considered that

within a class of assets some might be over-collateralised while others might be under-collateralised. Hence, aggregate disclosure of the fair value might be misleading. Therefore, the Board proposes to remove the requirement in paragraph 37(c) to disclose the fair value of collateral and other credit enhancements. However, the Board believes that information on the financial effect of such assets is useful to users. Hence, the Board decided to require disclosure of the financial effect of collateral held as security and other credit enhancements in paragraph 36(b).

Collateral and other credit enhancements obtained (paragraph 38)

BC56A As part of the *Annual Improvements* 2008-2010 cycle, the Board decided to clarify that entities need disclose only the amount of foreclosed collateral held at the reporting date in paragraph 38. The Board noted that this is consistent with the objective in IFRS 7 to disclose information that enables 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.

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Proposed amendment to guidance on implementing IFRS 7 *Financial Instruments: Disclosures*

A heading and paragraphs IG3 and IG4 are deleted (new text is underlined and deleted text is struck through).

Introduction

~~Materiality~~

IG3–IG4 [Deleted] ~~IAS 1 *Presentation of Financial Statements* notes that a specific disclosure requirement in an IFRS need not be satisfied if the information is not material. IAS 1 defines materiality as follows:~~

> ~~Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.~~

~~IG4~~ ~~IAS 1 also explains that definition as follows:~~

> ~~Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25 that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.~~

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Appendix B – Proposed drafting edits from Exposure Draft

B1. This appendix includes the proposed drafting edits from the proposed amendment included in the exposure draft of proposed Improvements to IFRSs published in August 2009. This appendix presumes all changes proposed in the exposure draft were accepted and only shows incremental changes newly recommended by the staff based on an analysis of the comment letters received. Incremental new text is double underlined and incremental deleted text is double struck through.

~~Proposed~~ Amendment to IFRS 7 *Financial Instruments: Disclosures*

Paragraph ~~33A~~ 35A is added. Paragraphs 34 and 36–38 are amended. Paragraphs 33 and 35 are not proposed for amendment, but are included for ease of reference. Paragraph 44I~~H~~ is added.

Qualitative disclosures

33 For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

~~33A The disclosures provided in accordance with paragraph 33 shall support and enhance the disclosures required by paragraphs 34 and 35.~~

Quantitative disclosures

34 For each type of risk arising from financial instruments, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in accordance with (a).

(c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

35 If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

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(a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that

do not qualify for offset in accordance with IAS 32); this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.

(b) a description and the financial effect of collateral held as security and other credit enhancements (eg a description of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument).

(c) information about the credit quality of financial assets that are neither *past due* nor impaired.

(d) [deleted].

37 An entity shall disclose by class of financial asset:

(a) an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and

(b) an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.

(c) [deleted]

Collateral and other credit enhancements obtained

38 When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose for such assets held at reporting date:

(a) the nature and carrying amount of the assets; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Effective date and transition

44HI *Improvements to IFRSs* issued in April 2010 added paragraph 35A and amended paragraphs 34 and 36–38. An entity shall apply the amendment for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

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Basis for Conclusions on ~~proposed~~ amendment to IFRS 7 *Financial Instruments: Disclosures*

This Basis for Conclusions accompanies, but is not part of, the ~~proposed~~ amendments.

BC~~2~~47A As part of the *Annual Improvements* 2008-2010 cycle, the Board decided ~~proposes~~ to remove the reference to materiality in paragraph 34(b) of IFRS 7. The Board noted that the reference could imply that disclosures in IFRS 7 are required even if those disclosures are not material, which was not the Board's intention.

Interaction between qualitative and quantitative disclosures

BC~~1~~47B As part of the *Annual Improvements* 2008-2010 cycle, the Board decided ~~proposes~~ to emphasise the interaction between qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments. The Board noted that providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The Board concluded that an explicit emphasis on the interaction between qualitative and quantitative disclosures will contribute to disclosure of information in a way that better enables users to evaluate an entity's exposure.

Credit risk (paragraphs 36–38, B9 and B10)

Maximum exposure to credit risk (paragraphs 36(a), B9 and B10)

BC~~3~~49A As part of the *Annual Improvements* 2008-2010 cycle, the Board decided ~~proposes~~ to clarifiy that the disclosure requirement in paragraph 36(a) applies only to financial assets whose carrying amounts do not show the reporting entity's maximum exposure to credit risk. The Board noted that 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. Moreover, the Board concluded that the requirement might be duplicative for assets that are presented in the statement of financial position because the carrying amount of these assets often represents the maximum exposure to credit risk. In the Board's view, the disclosure requirement should focus on the entity's exposure to credit risk that is not already reflected in the statement of financial position.

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Financial assets that are either past due or impaired (paragraph 37)

BC~~5~~55A As part of the *Annual Improvements* 2008-2010 cycle, the Board considered the usefulness of disclosure of the fair value of collateral and other credit enhancements required in paragraph 37(c). The Board considered that within a class of assets some might be over-collateralised while others might be under-collateralised. Hence, aggregate disclosure of the fair value might be misleading. Therefore, the Board proposes to remove the requirement in paragraph 37(c) to disclose the fair value of collateral and other credit enhancements. However, the Board believes that information on the financial effect of such assets is useful to users. Hence, the Board decided ~~proposes~~ to require disclosure of the financial effect of collateral held as security and other credit enhancements in paragraph 36(b).

Collateral and other credit enhancements obtained (paragraph 38)

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~~Proposed~~ ~~a~~Amendment to guidance on implementing IFRS 7 *Financial Instruments: Disclosures*

A heading and paragraphs IG3 and IG4 are deleted.

Introduction

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> ~~Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.~~

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> ~~Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25 that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.~~

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