Submission of Comments by the AASB to the IASB

Australian Government

Australian Accounting
Standards Board

Exposure Draft
ED 7 *FINANCIAL INSTRUMENTS: DISCLOSURES*

Comments to be received by 22 October 2004

INVITATION TO COMMENT

In response to the IASB Invitation to comment, the Australian Accounting Standards Board has prepared the following submission addressing the specific questions asked and commenting on the proposals in the IASB ED.

IASB ED 7 FINANCIAL INSTRUMENTS: DISCLOSURES

INVITATION TO COMMENT

The International Accounting Standards Board invites comments on any aspect of this Exposure Draft of its proposed IFRS *Financial Instruments: Disclosures*. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than 22 October 2004.

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

The draft IFRS incorporates disclosures at present contained in IAS 32 Financial Instruments: Disclosure and Presentation so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).

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

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

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

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

The AASB considers that the proposal to locate all disclosures about financial instruments in one Standard is consistent with the transaction focus of IFRSs. In addition, we consider that the proposed additional disclosure requirements provide information that is relevant to an enhanced understanding of exposure to financial instruments of both financial and non-financial institutions. Accordingly, we support both proposals.

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?

Generally, the AASB supports the proposal. We consider that subject to striking an appropriate balance between benefit and cost, the reporting of the fair value of collateral pledged as security and other enhancements, improves users understanding of an entity's exposure to credit risk as compared with making credit related disclosures without such information. Paragraph 39 of the draft IFRS articulates an impracticability exception to the proposed requirement. A requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so (IAS 1 *Presentation of Financial Statements* paragraph 11). The AASB acknowledges that there might be occasions when a cost-benefit assessment might cause an entity to not report the fair value of collateral pledged as security, for example, the mortgaged properties that secure a portfolio of loans and receivables. However, the AASB considers it unlikely that the entity could make use of the impracticability exception in the occasion illustrated. Accordingly, the AASB considers it appropriate that the benefit and cost requirements articulated in the *Framework for the Preparation and Presentation of Financial Statements* apply and that the paragraph 39 impracticability exception is removed. The AASB suggests that the draft IFRS require an entity that does not report the fair value of collateral pledged to disclose the accounting policy adopted.

The AASB is concerned that the proposed amendments to IFRS 4 do not articulate well the extent to which the disclosures about an entity's exposure to credit risk apply to insurance contracts which have credit risk as an inherent insurance risk, such as credit insurance and financial guarantees. When credit insurance and financial guarantees are within the scope of IFRS 4, the liabilities that arise from these insurance contracts are measured using a base that is substantially fair value. In this context, we do not consider that the additional requirement to disclose the fair value of the collateral inherent in these contracts provides information that is relevant to an enhanced understanding of exposure to financial instruments.

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 AASB supports the proposal to require sensitivity analysis. As part of these disclosure requirements we would also endorse the addition of the disclosure requirements of subparagraph 60(a) of IAS 32 requiring the disclosure of significant terms and conditions of financial instruments to the extent that they may affect the amount, timing and certainty of future cash flows. These may not be immediately apparent through sensitivity analysis, in the case of financial instruments such as embedded derivatives or options that are only triggered upon certain criteria being met.

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?

The Framework paragraph 102 comments that, under a physical concept of capital, capital is regarded as the productive capacity of the entity based on, for example, units of output per day. In addition, paragraph 102 comments that the financial concept of capital is adopted by most entities in preparing their financial statements. Under the financial concept of capital, capital is synonymous with the net assets or equity of the entity. Paragraph 49(c) of the Framework comments that equity is the residual interest in the assets of the entity after deducting all its liabilities. Paragraph 103 comments that the selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. Subparagraph 47(a)(i) and (b)(ii) of the draft IFRS propose that an entity shall disclose qualitative information and summary quantitative data about what it regards as capital.

The AASB agrees that when entities are subject to external capital requirements (e.g. regulatory capital requirements established by legislation in respect of financial institutions) they should be required to disclose information about that capital. However, the AASB is concerned that when an entity is not subject to external capital requirements the application of the draft IFRS proposal that an entity make disclosures about what it regards as capital might:

(a) sometimes result in the disclosure of information about capital that is not consistent with the Framework. We consider that in concept, the appropriate approach is for the IASB to re-debate the nature of capital, and on concluding that process then develop disclosure proposals that are consistent with the Framework. As an interim measure we consider that the final IFRS should clarify how subparagraphs 47(a)(i) and (b)(ii) relate to the Framework; and

(b) reduce the comparability of the financial reports of different entities (within the same jurisdiction and across different jurisdictions).

Subparagraphs 47(d) and (e) require disclosure of an entity's performance against internal capital management targets. These disclosures are not required for an entity's performance against other internal benchmarks (e.g. an entity's performance against budgeted revenue). The AASB is concerned that the disclosure of an entity's performance against internal capital management targets in isolation of an entity's performance against other internal benchmarks might not enhance users' understanding of the entity's performance.

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 AASB agrees with the proposed effective date and transition requirements. The current version of IFRS 1 *First-time Adoption of International Financial Reporting Standards* gives an exemption to an entity that adopts IFRSs for the first time before 1 January 2006 from the requirement to restate comparative information as if the requirement of IAS 32 and IFRS 4 had always applied. Accordingly, the AASB consider it appropriate that IFRS 1 be amended so that the IFRS 1 exemption will also apply when an entity both adopts IFRSs and the draft IFRS for the first time before 1 January 2006.

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 AASB agrees that the disclosures proposed by the draft IFRS should be part of 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 AASB agrees that the risk disclosures should be amended to make them consistent with the requirements in the draft IFRS.

Paragraph B10 of Appendix B (Amendments to other IFRSs) to the draft IFRS proposes that paragraph 39 of amended IFRS 4 require information about insurance risk that includes a "sensitivity analysis, showing the effect on profit or loss and equity of reasonably possible changes in variables that have an effect on them". The current version of IFRS 4 paragraph IG52 comment that "sensitivity analysis might be qualitative, and preferably also quantitative". Paragraph B10 of Appendix B does not propose an amendment to the words in paragraph IG52 of IFRS 4. It is unclear how the new wording fits with the words used in paragraph IG52.

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 AASB considers that the Implementation Guidance would be improved by the addition of illustrative examples of qualitative and quantitative disclosures, and the application of the minimum disclosures.

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 FASB ED Proposed Statement of Financial Accounting Standards *Fair Value Measurements* proposes a broad disclosure objective, which the FASB expects to use as a basis for considering more specific disclosures in pronouncements that require fair value measurements on a project-by-project basis. In addition, paragraph C65 (Background Information, Basis for Conclusions, and Alternative Views) of Appendix C to the ED comments that "the Board is addressing reporting issues broadly in its project on financial performance reporting by business enterprises. However, based on input received from the UAC and others, the Board concluded that until such time as a final statement in that project is issued, the disclosures required by this Statement would provide information that is useful to users of financial statements in assessing the effect of the fair value measurements used in financial reporting".

The AASB encourages the IASB to continue its work on the performance reporting project to promote consistency in the nature of the disclosures required of both financial and non-financial assets and liabilities that are measured at fair value. As an interim step, we consider the draft IFRS provides adequate disclosure of fair value and is consistent with the disclosure requirements under the FASB ED on the determination of fair value and effect of remeasurement on financial performance.

Question 10 – Other comments

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

Parent entity reports

In the process of making AASB 130 *Disclosure in the Financial Statements of Banks and Similar Financial Institutions* and AASB 132 *Financial Instruments: Disclosure and Presentation*, the Australian equivalent standards to IAS 30 and IAS 32, the AASB considered whether there should be relief for parent entities from certain disclosures required by AASB 130 and AASB 132 when the financial statements of the parent entity are presented with the group's financial statements, and the group's financial statements apply, either or both Standards. As part of that process the AASB noted that:

(a) the European Union's requirement that all companies listed on regulated markets in the EU prepare consolidated accounts on the basis of IFRSs;

(b) in some countries within Europe, when parent entity financial statements are presented with the financial statements of the group, the parent entity financial statements are not prepared on the basis of IFRS; and

(c) fund managers, capital markets and international investors would be experienced in making judgements about group financial statements that make a statement of compliance with IFRSs (and the accompanying parent entity prepared financial statements make no statement of compliance with IFRSs).

The AASB considered all benefits and costs in relation to financial reporting generally and concluded that the benefits to users to be derived from certain disclosures required by AASB 130 and AASB 132 in the financial statements of the parent entity when presented with the group's financial statements do not outweigh the costs of collecting and presenting that information. Accordingly, the AASB decided to provide the option for relief to the parent entity via the inclusion in both Standards of an "Aus" paragraph and an amendment to AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* (the Australian equivalent standard to IFRS 1) to ensure that a for-profit parent entity that makes use of the relief in AASB 130 and/or AASB 132 is within the scope of AASB 1.

When the AASB issued the IASB ED in Australia with an Australian Preface as ED 137 "Request for Comment on IASB ED 7 *Financial Instruments: Disclosures*", the Preface proposed that the entity application paragraph in the Australian equivalent of the IFRS that arises from this ED would state that, if a financial report contains both the separate financial statements of the parent and the consolidated financial statements of the an entity, the disclosures required by paragraphs 7-48 of the draft IFRS need be presented only for the consolidated financial statements. The AASB considers that its earlier assessment of benefits and costs remains valid and it appropriate that the option for relief to the parent entity be part of the final IFRS.

Additional disclosures of standby arrangements

In addition, the Preface proposed that users' understanding of the financial position of the entity is enhanced by the disclosure of information about the credit standby arrangements of the entity, including the nature of each arrangement and the total amount of credit unused and a summary of the used and unused loan facilities of the entity and the extent to which these can be continued or extended. The AASB considers it appropriate that these disclosures be part of the final IFRS.