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Deloitte Touche Tohmatsu

21 October 2004

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

ED 7 'Financial Instruments: Disclosures'

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (IASB) Exposure Draft 7 *Financial Instruments: Disclosures* (the ED or ED 7).

We support the issuance of a new Standard that contains all disclosure requirements in relation to financial instruments of any entity. We believe the issuance of such a standard will enhance comparability of financial reports, and ensure consistent disclosures in relation to financial instruments, particularly by entities whose primary operations are not in financial services sectors.

In the attached Appendix we have noted our concerns as to some aspects of the proposed approach and our responses to the specific matters on which comment was requested.

We appreciate the opportunity to provide our comments. If you have any questions concerning our comments, please contact Ken Wild in London at (020) 7007 0907.

Sincerely,

Deloitte Touche Tohmatsu

Appendix
Comments of Deloitte Touche Tohmatsu on
ED 7 Financial Instruments: Disclosures

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
b) information about any allowance account
c) income statement amounts by classification
d) fee income and expense.

Are these proposals appropriate? If not, why not, what alternative disclosure would you propose?

We support the proposal to locate all of the disclosure requirements of IAS 32 in one standard together with additional new disclosure requirements. We believe this approach enhances the extent to which IFRS can be considered user-friendly.

We believe it is appropriate to require the disclosures of financial assets and financial liabilities by classification. The classification of financial instruments in accordance with IAS 39 has a significant impact on the way they are measured on an ongoing basis, and we believe disclosure of each classification will assist users in understanding the extent to which accounting policies as disclosed in the accounts will affect the future recognised values of financial assets and financial liabilities. However we note that it is unclear whether hedging derivatives are, according to the IASB, a specific class of financial instruments requiring disclosure as they are not identified as such in the draft Standard. ED7-10 requires disclosure of the carrying amounts of financial assets/financial liabilities at fair value through profit or loss (showing separately those classified at held for trading and those designated by the entity as at fair value through profit or loss). However IAS 39.9 specifically excludes hedging derivatives from the definition of financial assets/financial liabilities at fair value through profit or loss. We feel that the lack of clear guidance in paragraph 10 could result in situations whereby, as an exception, the fair value of hedging derivatives is not disclosed.

We believe that the requirement to disclose a reconciliation of any allowance accounts is appropriate. We would recommend that the requirement to include a reconciliation be laid out in a manner similar to the requirements in respect of provisions (IAS 37.84). This will ensure users have a consistent understanding of what is intended when a requirement to disclose a reconciliation is incorporated into a standard. We believe that in addition to a requirement to disclose the opening and closing balances, the minimum requirements for reconciling information should be those currently required by paragraph 43(b) of IAS 30.

We believe it is appropriate to require the income statement amounts to be shown by their classification, as this will assist users in understanding the impact of an entity's accounting policies on the reported results. However we would encourage the Board to clarify the notion of net gains and losses. We feel that paragraph 21 b) is particularly misleading as it could be concluded that net gains and losses on assets/liabilities measured at amortized cost can include interest income/expense. Additionally, we believe it is unclear whether net gains and losses include gains and losses arising from:

- derecognition of the instruments and /or;
- changes in the carrying amount due to impairment or reversal of impairment or forex effects ;

- changes in the carrying amount of the assets/liabilities due to fair value hedge relationships.

We believe that this lack of guidance could result in potential abuse or in a lack of comparability of financial statements.

We believe the disclosure of fee income/expense is appropriate. However, we believe that such disclosure should only be required where it is consistent with the application of IAS 18.35 – that is that the fee income forms a significant category of the entity's revenue (and by analogy, only where it forms a significant category of expenses). We do not believe disclosure of fee income or expense where it is not significant to the activities of the entity as a whole is valuable. We note that the Board has endeavoured to draft a standard which requires that information only be disclosed to the extent it is significant to the entity, but as noted in our additional comments below, we are not convinced that the ED as drafted has achieved the intended objective. In this particular instance we note that paragraph 8 of the draft Standard states that an entity can choose how best to satisfy the information requirement of the standard *'without combining information with different characteristics'*. We believe it would not be possible to combine fee income/expense with other items without flouting this requirement, and therefore an entity would only be excused from this disclosure requirement on the grounds of materiality. We note that some will consider materiality through the eyes of their auditors, while others will use existing quantitative guidance (e.g. in Australia it would be reasonable for entities to rely on the guidance in AASB 1031). We believe 'significance' as used in IAS 18 is a higher and more appropriate threshold than 'materiality' and accordingly believe that the fee income/ expense should only be required to be separately disclosed where it is significant to the activities of the entity as a whole.

Question 2 – Disclosure of 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. Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

We note the requirement to disclose the fair value of collateral accepted applies to both financial and non-financial assets. We are concerned that this may cause problems where intangible assets have been accepted as collateral (as can happen in venture capital type loan arrangements). While the basis for conclusions (see following paragraph) would indicate that disclosure is not required where it is impracticable, we believe that entities may wish to disclose the fair value of intangibles accepted as collateral, but at the same time would be unable to recognise the fair value of a similar asset on their own books, which gives rise to questions about consistency within IFRS, and could be misleading where an 'own asset' carried at cost is clearly reported at a significantly lower value than a disclosed asset accepted as collateral. This appears to be an incongruous result as unless there is an active market for the intangible the entity is not permitted to recognise the fair value and eliminate this inconsistency. We recommend that the requirement to disclose the fair value of assets accepted as collateral be limited to financial assets and tangible assets.

We also note that paragraph BC28 states that the Board agreed not to require the disclosure of fair value of collateral pledged where this is impracticable. While paragraph 39(b) contains an impracticability clause, paragraph 16 does not. We are unsure as to how the interaction between the two paragraphs is intended to work – it would appear that the IASB believes that it will always be practicable to determine the fair value of assets pledged that the entity is able to sell or re-pledge in the absence of a default (para 16) but not those which it cannot sell or repledge. In the absence of any actual sale or repledging of the asset in question we see no reason why one case should have an impracticability let out and the other should not. Accordingly we believe it would be appropriate to either delete paragraph 16(a) or to insert an impracticability clause into this paragraph.

Furthermore, we support the requirement to disclose the carrying amount of financial assets pledged as collateral for liabilities and contingent liabilities. We note that the requirement in paragraph 15 requires disclosure of financial assets pledged as collateral, but then goes on to require the disclosure of *'terms and conditions relating to assets pledged as collateral'*. We believe the standard should say *'terms and conditions relating to financial assets pledged as collateral'*. Alternatively, the requirement to disclose the carrying amounts and the requirement to disclose terms and conditions should be separated into two separate paragraphs to assist users in noting the distinction that the first part of the requirements apply to financial assets pledged as collateral and the second to all assets pledged as collateral.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis. 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 of enabling users to evaluate the nature an extent of market risk?

We believe the inclusion of a requirement to disclose a sensitivity analysis for market risk in relation to financial instruments will provide useful information to users. We believe that entities that are exposed to sufficient market risk to trigger this disclosure, as a general rule, should have the capability to prepare a sensitivity analysis. However, we are concerned that this information may not be readily auditable. Whilst we accept that the IASB is not responsible for auditing procedures and standards, we believe that the IASB must acknowledge that the information it requires will be included in financial reports which are commonly required to be audited, and take account of auditability concerns in developing a final standard.

If the IASB decided to continue with this requirement we would suggest further guidance (perhaps by way of illustrative example) be provided as to what a *'reasonably possible change in the relevant risk variable'* consists of. We believe that different entities would interpret this requirement in different ways – some basing what is 'reasonably possible' on past trends, others on future forecasts, and others might interpret this as incorporating the extremes of history (for example interest rates as low as they have been at any time during the instrument's life, despite the evidence that market interest rates are rising). We believe that such guidance should also incorporate guidance on how to interpret this phrase when reporting in a hyperinflationary economy.

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 objective, 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.*

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

We believe that such information should be made available to users, and should not be limited to externally imposed capital requirements. However, we feel that at this point in time, that it is not appropriate for IFRS to require this disclosure in IFRS financial statements. We do not believe the proposed disclosures are consistent with existing IFRS, for example the disclosure *'a description of what it regards as capital'* is meaningless in a reporting framework in which capital is defined as the net assets of the entity. Accordingly, we believe this disclosure should be withheld until such time as the Board has re-opened discussions as to the nature of capital and concluded in a manner which will allow the development of disclosure requirements consistent with the definition. In the interim we believe that this is a matter best addressed on a jurisdictional basis by securities regulators, who are better able to develop requirements consistent with their own frameworks (those frameworks incorporating the requirements of IFRS) that meet the needs of users. We do not believe the proposed disclosure under IFRS would provide sufficiently comparable information to make it worthwhile at this time.

If the capital requirements are retained in the final standard, the final standard should clarify how they relate to the definitions of capital (financial concept and physical concept) contained in the *Glossary of Terms*, and the principles in relation to capital maintenance as laid out in the *Framework for the Preparation and Presentation of Financial Statements*.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged. 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. Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

We believe that generally, the proposed effective date is appropriate, however please refer to our concerns below in relation to the insurance industry. We note that certain disclosures, such as the requirement to disclose value of items used as collateral, will require significant information gathering exercises that not all entities currently complete, and accordingly, we believe it would be appropriate for entities to receive significant advance warning of the new disclosure requirements. Therefore we believe that the IASB should prioritise the completion of this Standard in order to provide an adequate period for entities to develop systems enabling the required disclosure. Accordingly we respectfully request that the IASB endeavours to complete the final standard by mid-2005.

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. Some believe that disclosures about risks should not be part of the financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements. Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

We agree that the disclosures of risks arising from financial instruments would provide useful information to users. We believe that the existing requirements of IAS 32 in relation to the risks arising from financial instruments have proved to be a useful and appropriate part of the financial report. However, in expanding these requirements, we believe the IASB should consider whether the requirements are genuinely appropriate to be mandatorily included within an IFRS financial report or whether entities might be given the alternative of including this information within the accompanying management information. We believe that the information requirements that are proposed may not be readily auditable, and therefore are not appropriate for inclusion within a financial report that must be audited. We note that for the year ended 31 December 2003 most entities we analysed chose to make disclosures of risk arising from financial instruments in the additional information provided by management outside of the financial report, and we see no reason why such placement of these disclosures should be considered a non-compliance with IFRS in the future.

Question 7 – Consequential Amendments to IFRS 4

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. Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's insurance project?*

We believe IFRS 4 should be amended to reflect the new disclosures required in respect of financial instruments. We note that the Board states in BC64 that the related amendments to IFRS 4 should take effect from 1 January 2007 with earlier adoption encouraged. This point was not clear from reading the consequential amendments to IFRS 4 as proposed in the ED and we are concerned that if they are simply processed as consequential amendments as they currently stand many entities will incorrect believe that they apply from 1 January 2005.

We agree with the Board that the consequential amendments should be treated as reissuance of a revised IFRS 4 with the same effective date and transitional provisions as proposed for the draft IFRS. It is not appropriate, nor consistent with the Board's policy in relation to the 'stable platform' to require disclosures that may not even be issued in standard format prior to 1 January 2005. Many insurance entities have begun in good faith an exercise to ensure they have all the information required by IFRS 4 in time for their adoption of IFRS. To add to those requirements at this time is burdensome and may be seen as contradictory to the Board's own due process policies. Accordingly we agree with the Board's suggestion that the amendments apply from 1 January 2007, and request that the Board give consideration as to how this can be appropriately reflected in the amended IFRS 4.

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. Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

We believe the Implementation Guidance is useful in demonstrating how an entity might satisfy the requirements of the draft standard, and do not propose any amendments.

Question 9 – Difference from the Exposure Draft of proposed Statement of Financial Accounting Standards *Fair Value Measurements* published by the US Financial Accounting Standards Board.

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 input were used), and*
    iii. *The effect of remeasurements on earning for the period (unrealized 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 the 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 earning for the period relating to those assets and liabilities still held at the reporting date.*

Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a). Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

We agree that the ED as drafted provides sufficient information as to the fair value of financial instruments. We believe that the additional disclosure requirements proposed by the FASB would be overly burdensome and would not provide useful information that is commensurate with the effort to obtain the information.

Question 10 – Other Comments

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

We are unclear as to the application of the draft standard to ‘unrecognised financial instruments’. Given the definitions in the Glossary of terms – that is that a financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another, it is difficult to see how an unrecognized financial asset or liability would ever arise given that items that meet the definition of asset or liability must be recognised. Interpretations of ‘unrecognised financial instruments’ may range from considering that these are non-existent (as argued above) through to inclusion of all financial contracts, executory contracts, unrecognized derivatives and potentially other items. The intention of the Standard should be clarified to explain that it applies to unrecognized financial items that do not satisfy the recognition criteria of IAS 39 – the current wording does not achieve this end.

We believe that paragraphs 7 and 8 of the draft Standard are unclear. They suggest that an entity makes only those disclosures that are appropriate to its circumstances, but do not clarify what exactly this means in practice when reading the rest of the standard, which clearly suggests that each paragraph is required disclosure, and therefore could only be ignored where it was immaterial (usually by virtue of being irrelevant). We believe that, particularly in respect of the risk disclosures, this may not be appropriate. For example, an entity that holds a material amount of investments with no intention to divest them, no significant focus on managing them (perhaps because they have been owned for a long time and are largely ignored), the risk disclosures would be difficult to comply with in a representationally faithful manner. We believe the standard should clearly state that information need not be disclosed where it is irrelevant or immaterial – given the focus in the standard on the way in which management mange the entity it does not seem to us that items which are irrelevant would necessarily be immaterial. We do not believe that including this information only within the Implementation Guidance is appropriate.

With reference to paragraph 21(b) we are unsure as to how a material (and therefore disclosable) situation would arise in which net gains or net losses could include interest and dividend income, given that these items are specifically identified as categories of revenue in IAS 18, and we see no clause within existing IFRS that would allow this revenue to be offset against other fair value gains or losses.

We believe that the disclosure required by paragraph 40(a) may cause unnecessary prejudice to entities in highly competitive markets. While an entity’s ‘official’ terms (i.e. 30 days) are normally a matter of public or easily obtainable knowledge, the extent to which entities in fact allow greater credit periods (often to some customers and not others) without considering this to be an impairment issue is often more closely held information. We believe that this disclosure requirement should be limited to listed entities (similarly to the manner in which the requirements for segment disclosures are limited in IAS 14 *Segment Reporting*) as we believe that for unlisted entities the proposed disclosure would be prejudicial to their management of their accounts receivable, without adding significant value to the users of the financial report.

We are confused by the amendment to the objective of financial instrument disclosures, (IFRS 4) such that rather than being able to ‘understand’ the amount, timing and uncertainty of future cash flows, users should be able to ‘evaluate’ the same. To ‘evaluate’ infers a quantitative, conclusive analysis, while to 'understand' infers consideration of all facts (quantitative and qualitative) to determine the likely future effects of holding the assets, that is possibly inconclusive. We believe the changes to the disclosures are more consistent with understanding rather than evaluation, and believe that the word 'understand' is more appropriate than 'evaluate'. Furthermore, we note that in our experience, when a word is changed in a standard, certain preparers will read much into that change, and others little – the objective of this change in terminology must be explained in the basis for conclusions in order to ensure that preparers respond appropriately. We also note that minor changes in language pose problems when standards are being translated, an explanation of the change in the basis for conclusions will assist translators in communicating the intent in the translated document.

We note that much debate has arisen as to whether an entity can allocate gains and losses on financial instruments in different line items in the income statement. We feel the lack of guidance in paragraph 21 could result in potential abuse whereby gains/losses on a financial instrument are allocated to different parts of the income statement based on an arbitrary split, regardless of whether the instrument is a designated hedging instrument. For example, if a cross-currency interest rate swap was not a designated hedging instrument, and therefore is classified as 'held for trading' in accordance with IAS 39, without specific guidance on presentation of gains/losses, some believe it would be possible to allocate part of gain/loss on the derivative to the 'interest' line, and part, say, to the 'sales' line, assuming part of the derivative was offsetting some of the foreign exchange risk on foreign currency denominated Sales. This presentation could apply even if no hedge accounting is being sought by the entity. We do not support such a presentation.

Furthermore, the wording taken from the Guidance on Implementing IAS 39 Q&A G.1 and incorporated into the draft Standard appears to condone an arbitrary splitting or 'componentisation' of fair value gains or losses on trading derivative instruments: "[DRAFT] IFRS X neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes [ED7.B7]." We believe trading gains or losses should never be split. This would be conceptually inconsistent with classification as a trading instrument, and any split of a trading fair value gain or loss would be not only arbitrary but, potentially misleading.

We believe it is a great opportunity as part of producing a new financial instruments disclosure standard to strengthen where instruments are presented in the income statement. We strongly believe that in the absence of hedge accounting, derivatives are by definition 'trading' and therefore should be presented in financing. Hedge accounting is a right that is earned, and provides privileges in allowing gains/losses on the hedging instrument to be recognised in the same line in the income statement as the gains/losses on the hedged item. This disclosure standard should reinforce this principle by providing explicit guidance on income statement presentation.

We note that the following disclosures have not been proposed by ED 7, and believe the Board should consider them for incorporation into the final standard

- Specific information regarding reclassifications of assets from one class to another (in addition to that required by paragraph 13), for example, reclassification from available for sale category into the held to maturity category and reclassifications out of the held to maturity category that are allowed under IAS 39
- The current disclosure requirement of IAS 30-26 in respect of loan commitments

We have noted that paragraph 42 of the draft Standard requires disclosure of liquidity risk for financial liabilities only. Disclosure of liquidity risk is more meaningful (particularly for a financial institution) if coupled with the maturity profile of financial assets since the 'net liquidity gap' is critical in assessing the entity's liquidity risk and is consistent with the liquidity management of most financial institutions. Furthermore IAS 1.54 requires current/non-current disclosure if the balance sheet is presented in order of liquidity. Disclosing the maturity profile of assets and liabilities would potentially meet the requirement in IAS 1.54.

We also believe that the final standard should clarify that whenever the standard refers to financial assets that are impaired, this includes all financial assets for which there is an objective evidence of impairment even if the calculated loss is nil, as defined in IAS 39.