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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Dear Sir David

Exposure Draft ED7 Financial Instruments: Disclosures

We are responding to your invitation to comment on the above exposure draft on behalf of the worldwide organisation and Global IFRS Board of PricewaterhouseCoopers.

We welcome the Board's decision to revise and enhance financial instruments disclosures. This exposure draft will ensure that users of financial statements are provided with greater transparency about an entity's exposure to risks arising from financial instruments and how those risks are managed.

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?

We agree that all disclosures regarding financial instruments should be located in one Standard. We also agree with the proposed additional disclosures above, as they are important in understanding the exposure of both financial and non-financial institutions to financial instruments.

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?

We recognise the value of this disclosure to users, however we believe the impractical exclusion is essential because many entities do not maintain this information for all loans and therefore it is not reasonable to impose a requirement to provide the disclosures. For example, many mortgage banks manage credit exposures based on the initial loan to value ratios, and monitor movements in the housing market to ensure that there is sufficient collateral to cover any losses in the loans. They therefore do not need to know the aggregate fair value of collateral. A qualitative description of the entity's policies for obtaining and managing collateral pledged as security will provide adequate information about how the entity mitigates the losses it expects to incur in the event of default.

It is important that any credit risk disclosures are consistent with the way an entity manages its exposure to credit risk. In particular, the proposals should require an entity to disclose its credit exposure after taking into account the effect of any legally enforceable master netting agreements. This was previously required by paragraph 50 of IAS 32.

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?

We welcome the requirement to provide quantitative disclosures based on the information provided internally to the entity's key management personnel. We recommend, however, providing additional guidance for less sophisticated preparers who may not monitor risks or present detailed risk information to management or the board of directors.

Additionally, we recommend retaining the disclosures previously required by IAS 32.60(a) regarding information about the extent and nature of financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows. This information may not always be evident from sensitivity disclosures. For example, the existence of a closely related embedded call option in an entity's issued debt may not be evident from a sensitivity analysis but would be useful for an understanding of the entity's exposure to market risk. Where such embedded options represent key terms and conditions, we recommend that they should be disclosed.

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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?

We agree that entities subject to capital requirements imposed by external regulators should be required to disclose non-compliance with those requirements and the relevant consequences. The level of an entity's capital and how it manages capital is an important factor in assessing the risk profile of an entity and its ability to withstand unexpected adverse events.

However, we question the appropriateness of extensive disclosures in the financial statements of other entities. In particular we do not support the imposition of a requirement to provide information about performance against internal capital management targets in their external financial statements. The discussion in paragraphs BC 45-54 acknowledges that only some entities set internal capital requirements and that practice varies by industry. This in itself suggests that it is inappropriate to mandate the proposed disclosures for all entities

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?

We agree with the proposed effective date and transition requirements.

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?

We agree that the disclosures proposed by the draft IFRS should be part of the financial statements. The financial statements would be incomplete and potentially misleading without disclosures about risks arising from financial instruments. An understanding of the risks associated with financial instruments and how they are managed by the entity is as important as understanding their accounting.

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?

We agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements of this proposed IFRS subject to the following comments. Proposed paragraph 39(iii) of IFRS 4 requires the amount of risk exposure to be disclosed. For insurance contracts, disclosure of absolute amounts will provide little in the way of quality information for users of the accounts since it ignores the effects of diversification. We recommend that the words "the amount of" are omitted from the paragraph. This will make the requirement consistent with those in paragraph 35 for financial instruments other than insurance contracts.

In the proposed new guidance for IFRS 4 in IG 62A, we believe that the reference in paragraph 50(a) should be to paragraph 42(a). The proposal makes the assertion that "the maturity date of insurance liabilities depends on when the insured event occurs". This is not the only factor influencing the timing of cash flows. Other factors, such as whether the insured even occurs or has already occurred, whether the insurance contract has a payout if an insured event does not arise, whether there are amounts payable on the lapse or surrender of the policy, or the settlement terms of a claim arising under the insurance contract, may affect the timing of the of cash flows. For some classes of insurance contracts a disclosure of estimated maturities will not provide meaningful information prior to the occurrence of an insured event covered under the contract. An alternative would be to disclose the mean duration of liabilities which would be calculated using data based on historical claims to determine the expected settlement pattern for both incurred claims and future claims arising from the unexpired risks at the balance sheet date.

Paragraph 41 of IFRS 4 should also be amended to specify the date on which the disclosure amendments proposed by this draft IFRS are effective, otherwise entities might conclude they are effective from 1 January 2005.

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 Implementation Guidance is sufficient for financial institutions. However we believe additional guidance should be provided for non-financial institutions. It would be helpful to include illustrative examples of the disclosures regarding the nature and extent of risk arising from financial instruments for corporate entities.

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?

We have advised the FASB in our response to their ED that we do not support all the disclosure proposals relating to the use of fair value. In particular we noted that the cost benefit constraints to the disclosure of unrealised and realised gains and losses for certain entities with trading activities which use fair value accounting, such as broker/dealers. Generally, the financial systems of these entities are not designed to separate the realised and unrealised portions. These systems would require significant modifications.

Question 10 - Other comments

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

1. The Board should clarify whether the minimum disclosures for balance sheet and income statement in paragraphs 10 & 21 are mandatory line items for the face of the balance sheet and income statement, or whether they can be included in the notes to the financial statements. Paragraph 43 of IAS 1 implies that in the absence of an explicit statement, an entity can select the most appropriate location for any disclosure. Additionally, the Board should clarify that the "other disclosures" set out in proposed paragraph 23-31 are mandatory.

2. Proposed paragraph 11(a) needs clarification. If the intention of this paragraph is to disclose the amount of fair value changes due to the change in the entity's own credit rating, this should be separately stated. The current disclosure will only achieve this result for straightforward debt instruments, a fairly narrow group. For other more complex financial liabilities designated at fair value, this disclosure requirement would not achieve this objective. We suggest that (a) be changed to required disclosure or the amount of change in fair value attributable to a change in the entity's own credit rating.

3. Paragraph 12 of this Exposure Draft proposes an estimation technique and is therefore only a clarification of paragraph 11. As such it should be moved to the Implementation guidance section rather than be included in the Standard itself.

4. We assume that proposed paragraph 21 (d) is also meant to capture the fee income and expense from investment management services that are separately recognised from long-term savings contracts as provided in IAS 18.A14(b)(iii). If that is the intention, that paragraph or the basis of conclusions should be clarified to ensure these income and expenses are explicitly captured.

5. Proposed paragraph 23(f) requires disclosure of the entity's policy for determining when financial assets are no longer past due. It is not clear what objective this disclosure requirement is addressing.

6. The assumptions used in the circumstances discussed in proposed paragraph 31(c) are typically interdependent. The impact of a change in a single assumption may not be meaningful in those circumstances. We recommend adding a qualitative disclosure regarding interdependency of assumptions, similar to that proposed in paragraph 44 for sensitivity analyses.

7. The disclosure regarding general banking risks in IAS 30 paragraph 50 provides useful guidance and therefore we recommend its retention as an industry specific disclosure for banks.

8. The proposed disclosures will have a significant impact on the separate financial statements of owner-managed businesses such as wholly owned subsidiaries and many small and medium-sized entities (SMEs). These entities will face major practical problems in adopting this exposure draft. For example, entities for which their risk management is entirely coordinated by a central treasury department will not separately maintain sensitivity information for market risks. By comparison, many SMEs will not have current systems to identify and monitor financial risks. It will be difficult and costly to obtain reliable information from the central systems related solely to a separate subsidiary or to install and operate new systems. Accordingly the Board should exempt such entities from the scope of this exposure draft.

9. There are many paragraphs that assume the fair value option in IAS 39 is not amended. Certain provisions of this exposure draft will need to be revisited if the Fair Value Option exposure draft or some version of it is introduced.

If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IFRS Board (+49 211 981 2905), or Ian D Wright (+44 20 7804 3300).

Yours faithfully

PricewaterhouseCoopers LLP