Ernst & Young

Ernst & Young Global Limited
Becket House
1 Lambeth Palace Road
London SE1 7EU

Phone: [44] 20 7980 2000
Fax: [44] 20 7980 0275

Web site: http://www.ey.com

22 October 2004

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

For the attention of: Ms. Andrea Pryde

Exposure Draft: ED 7 Financial Instruments: Disclosures

The global organisation of Ernst & Young is pleased to submit its comments on the Exposure Draft: *ED 7 Financial Instruments: Disclosures* ("ED 7").

We are concerned that some of the proposed disclosures provide limited value if given at a high level, but also recognise that too much detail at a certain level within the entity can be misunderstood. Additionally, some of the proposed disclosures would result in the disclosure of proprietary information by the entity.

The disclosures for an individual entity that is a member of a group provide limited value relative to the additional cost and administrative burden of providing these disclosures. Accordingly, we recommend that the IASB provide an exemption from scope for entities that are members of a consolidated group that publishes IFRS financial statements.

Overall, we believe that disclosures should require judgement and flexibility by the preparer, thereby enabling an entity to disclose the most relevant information in the most appropriate format. The proposed disclosures appear to be based on rules rather than on the principle of presentation of information that is relevant and useful to the reader of the financial statements.

One of the difficulties in merging the disclosure requirements of IAS 30 and IAS 32 is that the requirements are generally more suited for financial institutions than for non-financial institutions. Some of the requirements (such as the sensitivity and capital disclosures) will entail significant implementation costs, involving data that management of non-financial entities may not normally use to manage the business. Also, by requiring this level of disclosure of financial risks, which is out of proportion to the required level of disclosure of the non-financial risks to which entities are exposed, the disclosures will often give an unbalanced perception of the true risks to the business.

Additionally, ED 7 provides no scope exemption for small and medium sized entities ("SME"). ED 7 cannot be finalised in isolation of the SME project and we strongly urge the Board to re-evaluate the appropriateness of the proposed disclosures in ED 7 to small and medium sized entities, especially those not within the financial services industry.

We recommend that the Standard be expressed, as far as possible, as a set of general principles and that much of the specific disclosure requirements in ED 7 be moved to the Application Guidance, to provide suggested illustrations for the disclosure principles. At the same time, we believe the risk and capital disclosures proposed by ED 7 should not normally be included in the financial statements: However, if they are not included elsewhere in an entity's Annual Report, then inclusion within the financial statements should be mandated.

Our responses to the specific questions on which you have requested comment are set out in the appendix to this letter.

Should you wish to discuss this letter with us, please contact David Lindsell on 020 7980 0106 or Tony Clifford 020 7951 2250.

Yours faithfully

Ernst & Young

Exposure Draft: ED 7 Financial Instruments: Disclosures

Appendix: Responses to specific questions:

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 the proposed disclosures will provide the users of the financial statements with relevant information regarding an entity's financial position and performance.

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?

ED 7 paragraph 16 requires the disclosure of the fair value of collateral accepted. We believe such a disclosure provides limited value to the user of the financial statements unless analysed in conjunction with the type of loan and credit quality. The reader of the financial statements may incorrectly conclude that collateralised loans are low risk and non-collateralised loans are high risk.

Additionally, an entity may have a population of loans that are over-collateralised and loans that are under-collateralised. The proposed disclosures in ED 7 would not provide the reader of the financial statements with this understanding.

We believe that an entity should have the flexibility to present disclosures on relevant information about the risks within their individual portfolios, of which collateral may form only a component.

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?

As mentioned above, we believe financial statement disclosures should be relevant and reflect the way in which an entity manages its risk. Most groups manage risk on a consolidated basis in order to take advantage of natural risk offsets and utilise designated trading, hedging and liquidity functions that may exist within the group.

Therefore, we believe that many of the proposed disclosures will not be relevant to the users of the financial statements at an individual entity level. Disclosures of risk exposures at an entity level could be misleading to the user of the financial statements at an individual entity level as it may suggest that there are exposures when, in practice, such exposures are hedged or offset at the consolidated group level. A lender to a subsidiary, generally, relies on parent company guarantees rather than the financial position of the subsidiary. Therefore, we believe that subsidiaries should be exempt from the disclosures unless the subsidiary has listed securities.

The Basis for Conclusions indicates that it is practicable for entities to prepare the proposed sensitivity disclosures as a result of the availability of new techniques for financial institutions to manage their risk. However, such techniques are not necessarily available to all entities and accordingly, will place an undue burden on many entities reporting under IFRS.

Additionally, for small and medium sized entities we do not believe the proposed sensitivity analysis disclosures will be relevant to the users of their financial statements. As noted above, we believe that small and medium sized entities, especially those not within the financial services industry, should be exempt from the disclosures.

We believe that disclosures should allow and require judgement and flexibility by the preparer thereby, enabling an entity to disclose the most relevant information in the most appropriate format.

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?

Ernst & Young does not agree with the proposals in the ED related to capital disclosures. Much of an entity's capital, and many of the risks that drive the requirements for capital, are not directly related to financial instruments. We are unclear as to why capital disclosures are contained in a draft standard on financial instruments disclosures.

We do not believe that capital disclosures for entities that do not have externally imposed capital requirements are currently useful to the reader of the financial statements. Common methods of capital calculation are not yet widely accepted, are not used by many entities, and would not enable meaningful comparison between entities. Prior to mandating capital disclosures for non-regulated entities, we recommend that the IASB conduct field-testing of the methods that might be used.

Further, we note that capital for entities within the financial services industry is, often, regulated on an individual entity basis and not on a consolidated basis. Therefore, the proposed disclosures will often not represent meaningful information in the consolidated financial statements.

Additionally, the proposals require the disclosure of breaches of regulatory capital requirements during the year. This could be sensitive information whose publication prudential supervisors are likely to wish to control.

We do not believe that capital disclosures should form part of the financial statements. Should the IASB continue to believe the disclosure of such information is necessary, we would recommend the placement of capital disclosures in the "Other financial review" section of an entity's Annual Report.

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 transition rules. Entities adopting IFRS for the first-time in 2005 may determine it is more efficient to adopt ED 7 in 2005 rather than wait until 2007. In this instance, we agree that the exemption from comparative information is necessary.

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 do not believe that capital and risk disclosures should be part of the financial statements. To do so would result in (1) substantial practical implications for auditors, and (2) place a substantial burden of additional audit costs on preparers. However, we agree that they should be provided in the financial statements if not given elsewhere in the Annual Report.

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 with the proposed amendments to the risk disclosures in IFRS 4 with the exception of the following comment.

If sensitivity disclosures are required, we do not believe that the disclosures should be limited to one side of the balance sheet (ie, the insurance risk) but instead should disclose the overall net impact to the entity. For entities in the insurance industry, a change in the fair value of a financial asset will frequently have an impact on a related insurance liability. Likewise, a change in the fair value of a financial liability may occur only when there is a change in fair value of a related financial asset.

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?

We do not believe the Implementation Guidance provides sufficient illustration of the application of ED 7, especially for non-financial institutions.

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 ED 7 proposed disclosures appear reasonable compared to the FASB *Fair Value Measurements Exposure Draft.*

Additionally, we would like to point out that the FASB proposed disclosures in (a) (ii) and (a) (iii) may be harmonised with the proposed disclosures in ED 7 but the underlying fair value hierarchy for each respective GAAP is different.

QUESTION 10 – Other comments

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

Paragraph 11:
We are uncertain what the disclosures proposed are attempting to accomplish. Presumably the intention is to disclose the proportion of the gain which is due to changes in an entity's own credit risk. However, the change due to the benchmark rate plus the change due to own credit risk will only equal the total change in fair value where there are no embedded options. This will include situations in which the embedded option would be required to be separately valued (such as where the principal is linked to equities or commodities, or where it is simply

denominated in a foreign currency) and where the derivative is closely related, such as most caps, floors and pre-payment or extension options.

Additionally, we believe any disclosures about the change in an entity's own credit risk should reflect any hedges entered into on its own credit risk that could offset this change.

Furthermore, we believe that sensitivity disclosure of changes in fair value for financial liabilities reported at fair value through profit or loss attributable to the benchmark interest rate may not be meaningful to the reader in certain situations. For example, certain insurance liabilities carried at fair value may have their fair value derived directly from the underlying assets. In this situation, a sensitivity disclosure is not meaningful as there will be little net impact for the entity. We recommend that the Standard should indicate that if the change in fair value of a financial liability is only derived from the change in the fair value of a financial asset, the sensitivity analysis disclosures are not required.

We are uncertain as to the meaning of the term "contractual maturities" in the context of paragraph 11(b). Are contractual maturities to represent cash flows expected to occur in the future? Does the IASB consider incurred but not reported (IBNR) claims for a general insurance entity to be considered a contractual obligation?

If the Board intends that entities should disclose the effects of the changes in own creditworthiness, then the Standard should clearly state this.

Paragraph 18:
We are uncertain as to the intended use of the word "multiple" in the context of paragraph 18. We agree that the proposed disclosure is appropriate but suggest the elimination of the word multiple from the text.

Paragraph 23(b):
We do not believe the disclosure of the accounting policy related to designation of available-for-sale financial assets is meaningful. Generally, an entity has accounting policies related to the designation of financial assets held-to-maturity, held for trading, or designated to be held at fair value with changes through profit or loss. Normally, the available-for-sale category is used for all financial assets that do not meet the criteria for designation in the other categories.

Paragraph 23(f):
We do not believe that the disclosures required by the paragraph will provide useful information. An item is "past due" until such time as it is paid. This is a matter of fact, and we do not believe a policy is required for this determination. It would be more useful to disclose an entity's policy for determining when loans are no longer impaired and when impairment reserves are released.

Paragraph 24:
We believe the required disclosures should include the changes in value of the items that receive hedge accounting.

Paragraph 30:
We believe the disclosure of the range in possible differences between the carry amount and fair value would provide the reader of the financial statements relevant information in the context of paragraph 30 and suggest the inclusion of this disclosure.

Paragraph 31 (b) and (c):
The wording of these sub-paragraphs lacks clarity. The use of the word "whether" suggests that all that is required is a 'yes' or 'no' answer. If quantification is the intention of the disclosure, then we suggest the wording needs to change accordingly.

Paragraph 39(a):
The wording of this sub-paragraph lacks clarity. "Maximum" exposure on a derivative would normally be taken to include potential future exposure as well as the current mark-to-market exposure. However, the guidance makes it clear that it is supposed to include only the current mark-to-market exposure on derivatives. "Maximum" is not the right word to use.

Paragraph 40(b) and (c):
It is not clear how much detail is required to be given by paragraph 40(b) and (c). Depending upon the nature of the entity's business (ie, banking vs. corporate) the amount of disclosure may vary. Without adequate illustration (refer to response to question 8 above) it is unclear what is expected.

Paragraph 41:
The disclosure requirements of paragraph 41 will often be very detailed. Similar disclosures in the aggregate would be more meaningful and useful.