The South African Institute of Chartered Accountants

CL 32

22 October 2004

Andrea Pryde
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Email: CommentLetters@iasb.org.uk

Dear Sir/Madam

EXPOSURE DRAFT ED 7 – *FINANCIAL INSTRUMENTS: DISCLOSURES*

In response to your request for comments on Exposure Draft ED 7 – *Financial Instruments: Disclosures*, attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), which is the official standard-setting body in South Africa.

We would like to thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Doug Brooking (Chairman of the Accounting Practices Board)
Prof Geoff Everingham (Chairman of the Accounting Practices Committee)

#80153

SAICA COMMENT LETTER ON ED 188

GENERAL COMMENTS

We support the Board's decision to revise and enhance the disclosure of financial instruments as contained in IAS 30 – *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and IAS 32 – *Financial Instruments: Disclosure and Presentation* and to group all these disclosures in one Standard. We are of the view that this proposed Standard will enhance comparability of disclosures for financial instruments for both financial and non-financial institutions.

However we have a major concern that the non-financial institutions (corporate entities) may now have 'out of balance disclosures'. For such an entity whose main business is not financial services, the disclosures for financial instruments may be excessive, relative to the disclosures for other more significant items in their financial statements. In catering for the needs of a wide range of entities, the proposed Standard has over-simplified the disclosure for financial institutions and overly burdened the disclosure for corporate entities. For example, the key disclosure for banks would be the disclosure of net interest income, which cuts across several classification categories and is not specifically required in the proposed Standard.

RESPONSES TO QUESTIONS RAISED

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?

As indicated above, 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 comparability and will assist users in better understanding the entity's exposure to financial instruments. However, we question whether this proposed Standard should not have been incorporated into IAS 32, rather than being a separate Standard, or alternatively whether the balance of IAS 32 should be incorporated into this Standard. It is cumbersome to have the accounting of financial instruments addressed in three different Standards, IAS 32, IAS 39 and this proposed new Standard.

Although we are of the view that it is appropriate to require the disclosure of financial assets and financial liabilities by classification, as this is in accordance with IAS 39 – *Financial Instruments: Recognition and Measurement* and has a significant impact on the way they are measured on an ongoing basis, for financial institutions this information is often more meaningfully presented by product and so would require further levels of disclosure within each of the above classifications. This should be noted in the Standard.

In our view the requirement to disclose a reconciliation of the movement of any allowance account is appropriate. However, there should be similar disclosures when no allowance account is used and the impairment is recognised directly against the financial asset. Further, paragraph 17 only applies to "*allowance account for credit losses*" and we are of the view that an allowance account may be used for impairments other than credit losses and so paragraph 17 should rather refer to an allowance account for any impairments of financial assets carried at amortised cost.

We believe it is appropriate to require the income statement amounts to be shown by classification, as this will assist users in understanding the impact of an entity's accounting policies on the reported results. Paragraph 21 (a) refers to "*net gains or net losses*" for financial assets and financial liabilities in the profit and loss statement. It is unclear whether each of these categories is required to be disclosed separately in the financial statements, or as an aggregate of all instruments carried at fair value in the profit and loss statement. This could create uncertainty, particularly when considering a derivative instrument for which the value fluctuates, resulting in either an asset or liability being recorded at a particular point in time.

We believe the disclosure of fee income/expense is appropriate.

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?

In our view the general proposals in paragraphs 39 and 40 are appropriate, except for the following comments:

- Financial institutions may find it too costly and time consuming to determine the fair value of collateral pledged in certain of their portfolios. Furthermore the fair value of portfolio collateral is only determinable based on sufficient history of defaults and workouts and in many cases the data may not be available.

- Paragraph 39(a) of the proposed Standard requires the disclosure of an entity's maximum exposure to credit risk without taking into account any credit enhancements. However, as regards market risk, the proposed Standard does not require disclosure of an entity's maximum exposure. In instances where an entity trades in credit risk, the requirement to disclose the maximum exposure to credit risk appears inconsistent with the principle governing the disclosure of market risk. This should be dealt with in more detail in this IFRS.
- These sections on credit risk should specifically deal with the use of *"master netting agreements"* that financial institutions enter into as defined in paragraph 50 of IAS 32. Without specific reference to *"master netting agreements"* in this Standard, these agreements may not be disclosed by financial institutions.
- The disclosure required in paragraph 39(c), *"information about the credit quality of financial assets with credit risk that are neither past due nor impaired"* is impracticable, difficult to assess and would not provide useful information for corporate entities. However, this is relevant information for financial institutions.
- Paragraphs 39(c) and 40 (a) refer to *"past due"*. The definition of past due is *"a financial asset is past due when a counterparty has failed to make a payment when contractually due"*. This definition assumes that there are always contractual terms, which is not always the case. We suggest the definition is changed to cater for non-formalised terms as well.
- Paragraph 40 (a) requires *"an analysis of the age of financial assets that are past due as at the reporting date but not impaired"*, which is effectively dealing with the deficiency in the impairment rules and should rather be addressed in the Standard on impairment.

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 support the proposed disclosure of sensitivity analysis for financial institutions, but suggest it is not practicable for corporate entities to provide this detail in respect of **all** financial risks to which they are exposed. For example, we cannot see difficulties for corporate entities to calculate sensitivity analysis for foreign exchange risk, but they may have difficulties with respect to sensitivity analysis for interest rate risk. We recommend that the Board field-test this proposal with corporate entities to determine whether they could comply with these onerous disclosure requirements.

For financial institutions, some detail has been lost from the original requirements in IAS 32.60(a), such as information about the interest rate gap analysis, which captured amongst others, the impact of non-linear instruments. Sensitivity analysis is not able to capture all relevant information relating to such risk exposures. As a further example the existence of a closely related embedded call option in an entity's issued debt may not be evident from a sensitivity analysis and it may be useful for an understanding of the entity's exposure to market risk for this to be disclosed.

We are concerned as to how an entity would provide these sensitivity analysis disclosures for risks experienced **during** the reporting period, as required in paragraph 32 of the proposed IFRS. We suggest the Board reconsiders this onerous requirement.

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 the level of an entity's capital and how it manages this capital is an important factor in assessing the risk profile of an entity and that such information would be useful to users and should not be limited to externally imposed capital requirements. However, it is not appropriate for IFRS to require this disclosure currently as the proposed disclosures are not consistent with existing IFRS. *"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, 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 that will allow the development of disclosure requirements consistent with the definition. In the interim, this is a matter best addressed on a jurisdictional basis by market regulators, who are more equipped to develop requirements consistent with their own frameworks (those frameworks incorporating the requirements of IFRS) that meet the needs of users and regulators in particular.

Further, for entities that are regulated, specifically financial institutions, the regulators would require this information and more as they have a different basis for assessing the adequacy of capital. We encourage the Board not to impose all Basel required disclosures in IFRS unless the Board views them necessary to ensure fair presentation of the entity's financial position.

If the capital requirements are retained in the final Standard, the 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 (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 are of the view that the Board should reconsider the effective date of the draft IFRS for the following reasons:

- Many entities who adopt IFRS for the first time in 2005, would apply IAS 30 and IAS 32 and be required to change their financial instrument disclosure two years later. Effectively this would mean restatement of comparatives and hence they would have to apply this from 2006.
- The effective date for the Basel requirements is 2008 and for financial institutions it would make sense to have the same effective date.
- Phase II of the insurance project is expected to make significant changes to the insurance industry and the disclosure of financial instruments for insurers may be different from these draft proposals. It is recommended that until phase II of the insurance project is formulated, it could result in unnecessary changes for the insurance industry.

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 disclosure of risks arising from financial instruments should form part of the financial statements and therefore should form part of IFRS. 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 necessary part of 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?

We agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements of this draft IFRS.

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 unclear from reading the consequential amendments to IFRS 4, as proposed in the draft Standard and we are concerned that, if these consequential amendments are simply processed as noted in the draft Standard, many entities would incorrectly interpret this to apply from 1 January 2005.

Please refer to our comment in Question 5 above on the proposals of effective date for insurance companies.

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, 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.

We are concerned that, by re-debating the status of the Implementation Guidance as noted in BC42 – BC44, the Board appears to have called into question the status of Implementation Guidance in general. In our view Implementation Guidance should never form part of a Standard.

Question 9 – Differences from the Exposure Draft of Proposed Statements 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?

As we do not generally deal extensively with the FASB Standards and are not so familiar with the FASB exposure draft, we cannot provide meaningful comment on this question.

Question 10 – Other comments

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

Paragraph 4

We are unclear as to the application of the draft IFRS 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 understand how an unrecognised 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, guarantees, executory contracts, unrecognised derivatives and potentially other items. The IFRS should be clarified to explain that it applies to unrecognised financial items that do not satisfy the recognition criteria of IAS 39.

Paragraphs 10 and 21

We request that the Board clarify whether the minimum disclosures for the balance sheet and income statement in paragraphs 10 and 21 are mandatory line items to be disclosed on the face of the balance sheet and income statement, or whether these 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.

Paragraphs 11 and 12

These paragraphs only discuss financial liabilities. However, the heading includes a reference to financial assets. This should be corrected.

Paragraph 12

This paragraph discusses a very specific issue for a financial liability of which the fair value is determined on the basis of an observed market price. Certain issues are not mentioned at all, for example a financial liability where there is no observed market price and you choose to fair value this liability. The Board should expand this section to cover this and other scenarios.

This paragraph refers to "*benchmark interest rate*", which is not defined in either IAS 32 or IAS 39. We recommend a definition be provided.

Paragraph 21(b)

This paragraph requires that for each category of income statement amount of net gains or net losses (per paragraph 21 (a)) an entity is required to detail whether these net gains or net losses include interest or dividend income. We do not foresee any difficulties with corporate entities having to comply with this paragraph. However, as regards financial institutions, one of the key areas of uncertainty is around the disclosure of the components of net interest income. Due to different definitions being applied by financial institutions as to what constitutes net interest income, the Board should provide clearer guidance on this matter, in order to achieve the objective noted in BC16.

Paragraph 23(a)

This paragraph requires the disclosure of *"the criteria for designating, on initial recognition, financial assets or financial liabilities as at fair value through profit or loss"*. In our opinion the disclosure of the "*criteria*" would not be of value to users, as these may be arbitrary.

Paragraph 23(d)

Refer to our comment on Question 1 regarding the allowance account, where we indicated that there should be similar disclosures for when no allowance account is used. Therefore the same disclosure requirement should be provided whether or not you use an allowance account.

Paragraph 30(a)

This paragraph requires the disclosure of *"the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably"*. The words "*measured reliably*" contradicts IAS 39, which states that the only time an entity cannot measure fair value reliably is in the case of unquoted equity instruments and derivates linked to and settled by such instruments. This paragraph is much broader and merely indicates that if an entity cannot measure the fair value reliably, this fact should be disclosed and brought in line with IAS 39.

Paragraph 31

For financial institutions, it would not be meaningful to disclose this information by class of financial asset and financial liability. It would be far more meaningful to disclose this by product line. The IFRS should cater for this.

Paragraph 31(a)

This paragraph requires the disclosure of assumptions relating to "*rates of estimated credit losses*". This wording contradicts the wording used in IAS 39, which refers to "*future credit losses*". The wording should thus be aligned to that in IAS 39.

Paragraph 42

Paragraph 42 refers to the disclosure of liquidity risk for financial liabilities only. The IFRS should require disclosure of liquidity risk for both financial assets and financial liabilities as the inter-relationship between the liquidity risk of financial assets and financial liabilities is particularly relevant in financial institutions.

This paragraph further requires the disclosure of "*contractual maturities*". This is not useful information. What should be required is the **expected** profile of maturities and how this compares to the "*contractual maturities*".

#80344