European Financial Reporting Advisory Group

**CL 104**

8 November, 2004

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

**Re: ED 7 *Financial Instruments: Disclosure***

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft 7 *Financial Instruments: Disclosure (ED7).* This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

In arriving at our comments we have consulted with the European national standard setters, international organisations and corporations.

We agree with the IASB in its objective to propose principle based disclosure requirements for financial instruments. We support the reduction in details of existing disclosure requirements in order to increase the overall quality of the disclosures.

However, we disagree that the disclosure of the fair value of collateral pledged as security as proposed in the Exposure Draft will achieve the objective to provide users with information about credit exposure of an entity in the event of default. We argue that this objective will be better achieved if entities are required to disclose amount of the credit exposure before and after taking account of the fair value of any collateral pledged in principle.

The Exposure Draft requires disclosure of any non compliance with internal or external capital requirements throughout the reporting period. We agree with the requirement to disclose external capital requirements. However we propose exempting minor breaches resolved by the balance sheet date from the disclosure requirement. Furthermore, we do not support compulsory disclosure of internal capital targets.

We agree that in the absence of any guidance in the IFRS on Management's Discussion and Analysis, disclosures about risk should be part of the financial statements. However, when there is a subsequent Standard on MD&A we would like to be able to consider this question again.

The appendix to this letter sets out our answers to the questions raised in the exposure draft and provides further details on the points mentioned above

If you would like further clarification of the points raised in this letter, Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen

**Chairman**

**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?

**Response**

In general, we agree with the proposals. However, in addition to the disclosure about an allowance account in paragraph 17, we recommend that the Standard requires disclosure of reconciliation for each class of financial assets of impairment losses recognised on individual accounts.

**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?

**Response**

We agree with the IASB's statement in BC27 that entities should provide information which will enable users to understand credit exposure of an entity in the event of default. However, in our opinion, disclosure of fair value of collateral pledged as security will not always achieve this objective and might be misleading.

First, information about fair value of collateral in excess of the maximum credit exposure is irrelevant. Second, when information about fair value of collateral is provided on an aggregated basis by class of financial instruments (in accordance with paragraphs 39 and 40), the excess of fair value of collateral over the maximum credit exposure for some financial assets in the class can disguise the shortage in coverage of credit risk for other financial assets in that class. In most cases, entities will not be able to use excess fair values of collateral for some financial instruments to cover under-collateralised financial instruments. Therefore, under such circumstances the disclosure as currently required by ED7 will be understating the real credit exposure of the entity.

We believe that users of financial statements will better understand credit exposure of an entity in the event of default if they are provided with information about the amount of the credit exposure before and after taking account of the fair value of any collateral pledged.

Disclosure presented in accordance with our proposal will better reflect the relationship between the collateral and the corresponding financial instrument, and will help to avoid producing misleading information.

If fair value of collateral significantly exceeds the maximum credit exposure entities would not be required to fair value collateral to produce the disclosure in accordance with our proposal.

However, if the economic conditions have changed since the financial asset was acquired causing fair value of the collateral to decrease below the maximum credit exposure, the disclosed amount of the credit exposure after taking into account the collateral should reflect this change.

At the same time, we agree with the IASB's observation that in some cases the requirement to take into account fair value of collateral regularly might prove onerous or that the fair value might be not readily available for all types of collateral. We support that the Standard should address these circumstances. However, the current exemption based on the "impracticability" as proposed in ED 7 is not clear enough and therefore may result in different interpretations.

We propose that the Standard better defines those situations where the entity does not need to refer to the fair value of collateral. However, we recommend that when information about credit exposure does not take into account fair value of collateral, entities should be required to disclose this fact and explain how management monitors the collateral pledged.

**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?

**Response**

We agree with the proposal that entities should disclose a sensitivity analysis to explain their exposure to market risk. We believe that it is also important that the Standard should not include any additional restrictions on how entities should perform this analysis.

**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?

**Response**

*Externally imposed capital requirements*

We support the proposal to disclose information regarding externally imposed capital requirements. However, we are aware that in some countries disclosure of non compliance may not be favored by regulators who establish this type of target.

Nevertheless, we note that paragraphs 47(d) and (e) require disclosure of any non compliance with internal or external capital requirements throughout the reporting period. In practice, regulators vary in the levels of risk at which their targets are set. In some jurisdictions a relatively low level of risk may constitute a technical breach of capital requirements. Disclosure in the year-end accounts of minor breaches of compliance during the reporting period which have since been remedied may be misleading to investors, and have a disproportionate effect on capital markets and policyholder behaviour. There is a danger that the information in the year-end financial statements will be taken out of context of the specific issues that gave rise to the breach earlier in the year, particularly if the issue was minor and has already been resolved.

Therefore we propose exempting minor breaches resolved by the balance sheet date from the disclosure requirement. This will be in line with the arguments set out in BC52, and will be in conformity with the common understanding that a regulatory breach of compliance is not present where agreed measures are in place to remedy that breach.

*Capital requirements set internally*

We believe that the disclosure with regard to capital requirements set internally is not necessarily needed. Companies usually consider internally set capital targets together with other financial targets which are equally important. The requirement to present only capital targets in isolation would not be particularly useful for users of financial statements because this would reveal only a part of the whole picture. Moreover, this information may be considered too sensitive for an entity to disclose.

Therefore, we do not support a compulsory disclosure of internal capital requirements. In addition, in our view example IE1 in the implementation guidance focuses on the dividend policy of the company and not on the capital management. We are also nervous that the example may lead to boiler plate and simplistic disclosure. If the IASB removes the disclosure requirement of internal capital targets the example will not be needed. Otherwise, we recommend that the IASB considers adjusting the example.

**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?

**Response**

We agree with the proposed requirements. However, we recommend that the Standard should clarify when IAS 30 ceases to apply, particularly in the case of an early adoption. We suppose that IAS 30 ceases to apply to an entity from the moment that the entity first applies the new Standard. We would like that this clarification is added in the Standard to avoid misunderstanding because this has an effect on comparative information.

**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?

**Response**

We share the supporting arguments described by the IASB in BC41. Therefore, we agree that disclosures about risk should be part of the financial statements. However, when there is a subsequent Standard on MD&A we would like to be able to consider this question again.

**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?

**<u>Response</u>**

We share the concern that for insurance companies it is not ideal to have further changes in their financial reporting a short time after having prepared for the implementation of IFRS 4. Further changes to disclosure requirements even if mandatory only from 2007 might be burdensome in adjusting systems.

However, we believe that it is a conceptually sound approach to amend disclosures in IFRS 4 at the same time as IAS 32 is revised, because IAS 32 was the main basis for IFRS 4 disclosures.

Furthermore, we are concerned that if the amendments to disclosures in IFRS 4 are delayed until Phase II of the insurance project is finalised, it may take a very long time before harmonisation between financial instruments disclosures and disclosures for insurance contracts is achieved. This might be a competitive disadvantage for insurance companies especially in those instances where the amendments would result in disclosures that are easier to prepare and would be more meaningful for the users.

**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?

**<u>Response</u>**

We believe that the implementation guidance is sufficient. We do not have any additional suggestions for the implementation guidance except for the illustrative example in IE1. Please see our response to question 4.

**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

(i) 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?

**<u>Response</u>**

We agree that fair value disclosures as proposed in ED 7 are adequate compared to those in the FASB's exposure draft. In addition to the ED 7 proposed disclosures mentioned in the question, we note that paragraph 10 requires disclosure of the carrying amounts of financial assets and liabilities under six categories. The FASB proposals would duplicate most of this.

**Question 10 – Other comments**

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

**<u>Response</u>**

- We note that the disclosure requirements in paragraphs 11 and 12 of ED 7 are taken from IAS 32 without significant amendment. The Basis for Conclusions for IAS 32 stated that the IASB reasoning behind these disclosure requirements was that the proposed disclosure would be a reasonable proxy for the change in fair value that is attributable to changes in own credit. However, if the financial liability contains an embedded derivative the fair value of that derivative may represent a significant part of the fair value change that is not attributable to changes in a benchmark interest rate.

  Therefore, for such financial instruments, the disclosure will not be a good proxy for the change in fair value that is attributable to changes in the liability's own credit risk. One of the purposes of the fair value option was to simplify accounting for financial instruments with embedded derivatives. Therefore, we foresee that the situation described above can be rather frequent.

  Furthermore, it is not always clear what would be the amount the entity contractually required to pay at maturity to the holder of the obligation required to be determined under paragraph 11 (b) if a financial liability contains an embedded derivative.

  We recommend that the IASB addresses these issues and provides an illustrative example how entities could provide the required disclosure in paragraphs 11 and 12 for financial liabilities with embedded derivatives.

- Error in table of concordance for IAS 30: Paragraph 53 which dealt with secured liabilities should be marked as either partially substituted by paragraph 15 of the draft IFRS or deleted. It cannot be part of IAS 39 (b) or 40 (c) because these paragraphs deal with financial assets.