THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

28 July 2008

Our ref: ICAEW Rep 80/08

Your ref:

Gavin Francis
Director of Capital Markets
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Gavin

IFRS 7 Financial Instruments: Disclosure

The Institute of Chartered Accountants in England and Wales is taking the opportunity to bring to your attention several first time implementation issues with IFRS 7 Financial Instruments: Disclosure. The analysis does not include issues relating to fair value disclosures arising from the current market situation, given the extensive consideration being given elsewhere to this.

Instead the analysis aims to bring to the IASB's attention some practical difficulties with implementation that arise from the drafting of the standard which we think should be considered for improvement in the short term.

Please contact me should you wish to discuss any of the points raised in the attached.

Yours sincerely

ICAEW Representation

ICAEW REP 80/08

IFRS 7 Financial Instruments Disclosure

Memorandum of comment submitted in July 2008 by The Institute of Chartered Accountants in England and Wales in response to the IASB paper on IFRS 7.

Contents | **Paragraph**

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) has taken the opportunity to comment on the issues experienced on first time implementation of IFRS7 *Financial Instruments: Disclosure* issued by the International Accounting Standards Board in 2005 for implementation by December year- end reporters in their published financial statements for 2007.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the initiative

Principles-based approach

4. Whilst we support a principles-based approach to developing standards, we believe that this IFRS does not always clearly articulate the principle that the mandated disclosures are trying to meet and sometimes requires disclosures that are contrary to the stated principle that the disclosures are "through the eyes of management". In our view, the overriding principle should be that the disclosure is providing useful analysis of amounts included in the financial statements and that these analyses should reflect the manner in which the related risks are managed. The most obvious example of this issue is the

b) most of the problems are due to the requirements of paragraph B14, which were considered guidance only in the *Exposure Draft (IG27)*, but became mandatory in the final accounting standard;
c) particularly for derivatives within trading portfolios, the requirement to show gross undiscounted cash flows for liabilities is likely to result in enormous numbers being disclosed that bear no relation to the real underlying liquidity risk arising, and distort the underlying risk further because of the focus on liabilities, ignoring payments to be made on derivatives that are financial assets;
d) even in a liquidation scenario, underlying cash flows for derivative contracts will very rarely result in requiring one way gross cash payments to be made; and
e) the requirement to disclose undiscounted cash flows is not only onerous but also misleading for financial instruments that are not expected to be held to maturity.

6. We recommend that the text in paragraph B14 is moved back to being implementation guidance only, so that it is clear that providing undiscounted and gross cash flow data are not mandatory. In addition, we recommend that financial liabilities managed on a fair value basis are either permitted to be excluded from the maturity analysis in their entirety, or that they may be included at a value and within a maturity bucket that is consistent with the way in which their liquidity risk is managed. For financial liabilities managed on a fair value basis this would generally be at their fair values in the earliest maturity bucket the reporting entity is most likely to stand ready to close out or sell the position (which would nearly always be short term). Such a presentation is, in our view, more appropriate and more in keeping with the spirit of IFRS 7.

7. We wish to draw attention to this particular implementation problem with IFRS 7 because of its wide impact and because the required information is misleading as well as onerous to produce.

8. More detailed comment on the components of this disclosure can be found below the table attached to this letter.

9. We would be pleased to provide further information about aspects of the standard which are difficult to interpret and disclosures that are difficult to produce and have doubtful usefulness.

	Requirement	Problems	Application in practice	Suggested solutions
1	**Classes of financial instruments and level of disclosure IFRS 7.6**			
	IFRS 7. 6 requires disclosure by class of financial instruments, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and take into account the characteristics of those financial instruments	Guidance on what is a class or what should be disclosed is not particularly clear (IFRS7 .6) and the available Application guidance B3 and B4 and Implementation guidance (IG5 and IG6) are also not clear.	Wide diversity of practice – some banks thought that 'loans' were a class. Others broke loans down into types of loans	Provide clearer IG, for example it would be helpful to clarify that the minimum requirement is at the balance sheet category.
2	**Through the eyes of management approach**			
2.1	IFRS 7.34(a) requires a 'through the eyes of management' approach to quantitative risk disclosures including management metrics. The standard indicates that a minimum data set should only be provided if management figures do not provide the information	Management may use data other than financial data to manage the business or the data they use may not be readily reconcilable to the line items required under external reporting requirements. Such measures may not be auditable, SOXable and /or Non-GAAP.	Diversity of practice	The quantitative disclosures required by IFRS7 should reflect the primary financial statements, i.e. they should provide analysis of the amounts in the financial statements but the analysis, such as maturities or concentrations, should be driven by how the underlying risks are managed.
2.2	IFRS 7.34(a) requires that disclosure for the reporting entity is 'based on the information provided internally to key personnel of the entity (as defined in IAS 24 *Related Party Disclosures)*'	The risk management disclosure requirements are based upon the premise that the level of disclosure is consistent with the level that financial instruments are managed internally. This will be the case for the ultimate parent's consolidated accounts but may not be the	For subsidiaries where IFRS is required, disclosure will often be made in line with the minimum disclosure requirements rather than based on established risk management processes that exist at a different entity reporting level.	Consider whether alternative disclosures may be appropriate for wholly- owned subsidiaries or groups where the results are included within a group reporting under IFRS 7. For example, - complete exemption for

		case for wholly- owned subsidiaries, or lower level groups, where internal risk management practices often involve managing financial instruments across entities rather than at the legal entity level.		such entities (similar to FRS 29 Financial Instruments: Disclosures) - disclosure permitted consistent with the basis of internal risk management information assessed at a higher group level. For example, VaR is permitted if the Group is assessed under VaR even though the individual entity is not assessed under VaR.
3	**Market risk**			
	IFRS 7.34(a) requires summary quantitative data about each risk at the reporting date arising from financial instruments.	Because overseas net investments are not financial instruments they are not captured by this requirement. Therefore, an unhedged US $ loan to a customer would be an exposure if paid out of a GBP functional Company, but not if paid out of a USD functional subsidiary of a GBP functional group even though any change in exchange rates would impact equity.	Most groups have complied with the letter of the standard. Others provided a table of net investments by currency with the carrying amount of the associated hedges (accounting and economic) and the resulting net exposure, but no sensitivity analysis.	There should be a requirement to disclose structural foreign exchange exposure. This would be useful information in relation to, for example, groups with foreign subsidiaries.
4	**Credit risk**			
4.1	Maximum exposure to credit risk, including a description of collateral and credit enhancements held, by class (IFRS	Inevitably this results in a large total that is difficult to explain – it will include assets which	Most have complied without much divergence in practice, except for the requirement to	The usefulness of this disclosure is doubtful especially given the other

	7.36(a))	have little or no credit risk. Inclusion of trading portfolio and derivatives at fair value is at least partially misleading.	present by class	credit disclosures (see below) and it should be removed.
4.2	Carrying amount of assets that would have been overdue or impaired had their terms not been renegotiated, by class IFRS 7.36	For a large portfolio of loans or trading assets where decision making is dispersed, it is very hard to gather this data in practice. The commercial terms of loans are renegotiated continuously and it is difficult to establish which loans are renegotiated with this motive. It is not clear whether this means loans renegotiated in the accounting period or renegotiated ever.	Most seem to have arrived at a disclosure.	Delete this requirement because we do not believe it provides useful information
4.3	An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired (IFRS 7.37(a))	IFRS7 stipulates that when a debtor misses an instalment the entire financial asset is overdue. Past due means missing any contractual payment when due ('1p, 1 day'). Large amounts end up in this category even when there is, commercially, no problem with the relationship or the asset, leading to difficulties of interpretation for the reader. The inclusion of trading portfolio items in this analysis is also problematic at least from a systems perspective. Past due is also surprisingly	Most have complied – however in general only loans and advances have been included although the standard requires all financial assets subject to credit risk	Revise the definition to being over 30 days overdue or some commercially accepted interval which indicates that there might be concerns over collectability. This is one area where a reasonable 'through the eyes of management' approach would have been more useful. Assets included in this table are not included in the credit quality analysis. Exempt trading portfolio and available for sale assets. Their carrying value is the sole

		difficult to define for corporate lending agreements.		indicator of their credit status.
4.4	An analysis of financial assets that are individually impaired (IFRS 7.37(b))	IFRS 7 and IAS 39 are not compatible in this area since IAS 39 permits a portfolio approach to homogenous balances – these are only rarely individually impaired until write off. What is meant by 'an analysis' is indicated but not required – the minimum disclosures are gross, allowance and revised carrying amount, by class.	There was diversity in practice. Some entities gave geographical and industrial analyses. Others gave bare minimum data. In some cases, even less was presented. The treatment of homogenous loans also differed – IFRS 7 has no requirement for any disclosure about these. Therefore, portfolios of loans with large (but portfolio level) impairment allowances against them could be included in the analysis of neither past due nor impaired (credit quality) or in the past due but not impaired table (time analysis)	Stipulate the treatment of homogenous loans and portfolio level impairment allowances Either stipulate requirements or only require the minimum requirement. There is a need to review the overall consistency of the impairment disclosures required by IFRS7 with the measurement requirements of IAS 39.
4.5	Collateral and other enhancements held against assets that are past due or individually impaired (IFRS 7.37(c))	In practice this is a difficult figure to obtain since it is not readily available for most commercial loans where collateral can take many forms – for example, parent guarantees, floating charges, insurance etc.	Not many banks gave much data except for mortgages where the value of the collateral held (houses) in respect of mortgages was often disclosed.	Abolish the requirement as it serves little purpose. The estimated proceeds of collateral, together with the time value of money, are reflected in the carrying amount. The impairment allowance additionally reflects the likelihood that the entity

		IFRS7 indicates that this should only be given if practicable. Many banks fell back on this in order to overcome the problem of providing meaningful disclosures for collateral.		expects loss on the asset.
4.6	Collateral and other enhancements obtained (IFRS 7.38)	IFRS7 does not specify whether this is the amount held at the balance sheet date or the amounts collected during the year. This paragraph is open to varying interpretations	Some presented the carrying amount held at the balance sheet date, others the amount of collateral taken in the year.	Clarify the intention behind this disclosure. An IAS39 style portfolio approach should be permitted for this disclosure.
5	**Liquidity risk**			
5.1	Concentrations (IFRS 7.34(c)))	As with Market Risk, the requirement to show concentrations is clear but is included in IFRS7.34. This makes it easy to overlook.	Most do not show concentrations.	Include the requirement for this in IFRS7.39 and be more explicit that it includes concentrations in funding sources.
5.2	Contractual maturity of liabilities	Liabilities expressly include all financial liabilities, including trading portfolio liabilities and derivatives whether held for hedging or held for trading. All trading portfolio liabilities are invariably managed on a fair value basis will be closed out or sold long before maturity and the contractual maturities of these instruments are not relevant to the management of the entity. Financial reporting systems do not capture this	Most have taken a 'hybrid' approach to make this requirement workable and more meaningful even if the strict wording of the standard forbids this.	Remove this requirement altogether. – it is an example of IG being put in the standard at the last minute without due process. Contractual maturities would not have identified Northern Rock as an outlier. This table has proved a distraction from meaningful disclosures. It is not prepared on a behavioural basis which is how banks manage. Additional detail on sources of funding is more useful.

		data and it is not used for management reporting. Thus it is very hard to populate and verify if an entity has a trading portfolio including, especially, derivatives. In addition IFRS7 does not deal with the presentation of perpetuals.*		It would be preferable to return to a table for both financial assets and liabilities based on expected maturities which is presently included in IG30 as voluntary additional disclosure.

***Contractual maturities of liabilities**
Regardless of how liquidity risk is managed, paragraph 39(a) requires an analysis of financial liabilities by remaining contractual maturity. Where the counterparty has a choice of when a liability may be paid, paragraph B12 requires amounts to be included in the analysis based on the earliest date on which the entity could be required to repay. However, no adjustment is permitted in respect of financial liabilities that are expected to be repaid earlier than the contractual maturity date. This includes financial liabilities that are managed on a fair value basis as part of the trading portfolio, which may be settled or closed out earlier than their maturity date in the near term in response to trading decisions, or at the request of the customer, even though there is no contractual obligation on the reporting entity to do so. The inclusion of such financial liabilities in a contractual maturity table is misleading, as it implies that the reporting entity's liabilities will be paid at a later date than is usually expected to be the case, as well as onerous t o prepare since this is not the way that such financial instruments are actually managed for liquidity purposes.

Undiscounted cash flows
Paragraph B14 requires the cash flows disclosed in the maturity analysis to be undiscounted. Use of undiscounted cash flows gives a full representation of the amounts that the entity would pay if the liabilities are retained to maturity, but this does not equate to the amount that would be payable should the reporting entity cease to be a going concern and is therefore unable to meet its liabilities as they fall due. This is because, in such situations, liabilities would normally be settled at their fair value at that point in time. Hence the analysis is not even 'worst case' as envisaged by BC 57, but requires disclosure of larger cash flows. For financial instruments that are managed on a fair value basis, determination of undiscounted cash flows is onerous to produce and of very limited value, especially if the instruments are usually closed out prior to their contractual maturity.

Gross up of cash flows
B14 (d) requires contractual amounts to be exchanged in a derivative contract to be shown gross if gross cash flows are to be exchanged, as in a currency swap. This requirement would result, for banks and similar financial institutions, in extremely large amounts being disclosed, that bear no relationship to the gross liabilities recorded in the balance sheet or to the actual underlying risks.
The requirement provides information that is of limited value and is also misleading, since there is no legal requirement to pay the gross cash flows if either the reporting entity or the counterparty defaults. In the event of default (including liquidation, receivership or administration) the fair values of derivatives are settled net. Otherwise, the gross payments will always be accompanied by gross receipts.
(It is true that, at the date of default by a counterparty, there is a possibility that the entity may have committed itself to make gross payments on amounts due on that day and will not, in fact, receive the amounts due in return, but the incidence of this is very low and is better regarded as a credit risk than a liquidity risk).

This information will be particularly misleading if, as will generally be the case, the derivatives do not run to their contractual maturities, but are closed out and so net settled at an earlier date.

Email: iain.coke@icaew.com

www.icaew.com