

16 September 2005

Status: Final**Effective date:**Accounting periods commencing
on or after 1 January 2007**Accounting impact:**Changes to the disclosure
requirements for financial
instruments

International Financial Reporting Bulletin

IFRS 7 Financial Instruments: Disclosures and
amendment to *IAS 1 Presentation of Financial
Statements – Capital Disclosures*

Background

The International Accounting Standards Board (IASB) has issued International Financial Reporting Standard 7 *Financial Instruments: Disclosures* (IFRS 7) and a complementary Amendment to IAS 1 *Presentation of Financial Statements – Capital Disclosures*. IFRS 7 introduces new disclosure requirements, and replaces IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and some of the requirements of IAS 32 *Financial Instruments: Disclosure and Presentation*.

The objective of IFRS 7 is to require disclosures that enable the users of financial statements to evaluate:

- The significance of financial instruments for the entity's financial position and performance; and
- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

IFRS 7 and the amendments to IAS 1 are applicable for accounting periods commencing on or after 1 January 2007. In common with many other new accounting standards, early adoption is encouraged.

Requirements**IFRS 7 *Financial Instruments:
Disclosures***

The scope of IFRS 7 is wide, and covers all risks arising from all financial instruments, whether they are recognised on balance sheet or not, with limited exceptions. Those not recognised on balance sheet include, for example, loan commitments and commitments under operating lease contracts.

The exceptions include:

- Interests in subsidiaries, associates and joint ventures;

- Contracts for contingent consideration in a business combination
- Employee benefit plans;
- Share-based payments; and
- Insurance contracts.

IFRS 7 applies to all entities, regardless of size or complexity. This means that for some companies, where the only financial instruments are trade receivables, trade payables, and cash and bank balances, the disclosures will be simple and brief. For other entities, the disclosures may be extensive.

The disclosures required fall into two principal sections, being:

- The significance of financial instruments for financial position and performance; and
- The nature and extent of risks arising from financial instruments.

The significance of financial instruments for financial position and performance

*Categories of financial assets and financial
liabilities*

*Financial assets and liabilities at fair
value through profit or loss*

Balance sheet

The carrying amounts of financial assets and financial liabilities are required to be disclosed, either on the face of the balance sheet or in the notes to the financial statements, by category as defined in IAS 39 (that is, assets and liabilities at fair value through profit or loss, held-to-maturity assets, loans and receivables, available-for-sale financial assets, and other liabilities).

Where a loan or receivable (or group thereof) has been classified as at fair value through profit or loss, additional disclosures are required, principally with regard to credit risk (including the maximum exposure to credit risk at the reporting date, changes in value during the period attributable to changes in credit risk, and the extent to which any related credit derivatives or similar instruments mitigate credit risk and have themselves changed in value).

Similarly, where a financial liability has been designated as at fair value through profit or loss, disclosure is required of the extent to which changes in fair value during the period are attributable to changes in credit risk. In addition, disclosure is required of the difference between the financial liability's carrying amount and the amount that is contractually required to be paid on maturity.

Reclassification

An entity might reclassify a financial asset to a category where it is held at amortised cost rather than fair value, or at fair value rather than amortised cost. In such cases, the amount transferred into and out of each category and the reasons for the reclassification are to be disclosed.

Derecognition Where an entity enters into an arrangement whereby it transfers financial assets to another party, some or all of the financial assets may not qualify for derecognition. In such cases, the nature of the assets and the risks and rewards to which the entity remains exposed are to be disclosed.

In addition, where all of the assets continue to be recognised, disclosure is required of their carrying amount and of the associated liabilities; where assets are recognised to the extent of the entity's continuing involvement, disclosure is required of the amount of that continuing involvement, the total carrying amount of the original assets and the carrying amount of the associated liability.

Collateral Where financial assets have been pledged as collateral for liabilities or contingent liabilities, the carrying amount of those assets is to be disclosed together with the terms and conditions relating to that pledge.

Where collateral is held, and the holder is permitted to sell or repledge that collateral in the absence of default by the owner of the collateral, disclosure is required of the fair value of the collateral held, the fair value sold or repledged, whether there is any obligation to return the collateral, and the terms and conditions associated with its use.

Allowance account for credit losses Where financial assets are impaired, instead of the carrying value of those assets being reduced an entity might record the impairment in a separate account. In such cases, a reconciliation of the impairment account is required, with this being given by class of financial assets.

Compound financial instruments with multiple embedded derivatives Complex financial instruments may be issued that, in addition to containing both liability and equity features, have multiple embedded derivatives whose values are interdependent. If so, disclosure is required of these features.

Defaults and breaches Where an entity has loans payable at its balance sheet date, disclosures are required for any defaults and breaches that have arisen. These comprise any defaults that have arisen during the reporting period, the carrying amount of any loans in default at the balance sheet date, and whether the default was rectified, or loan renegotiated, before the financial statements were authorised.

In addition, if there were any other breaches of loan agreement terms during the reporting period that resulted in the lender being capable of demanding early repayment, the same disclosures are required unless the breach was rectified, or terms of the loan renegotiated, on or before the reporting date.

Income statement and equity

Items of income, expense, gains or losses Certain specified items of income, expense, gains or losses are required to be disclosed either on the face of the financial statements or in the notes. These include:

- Net gains or losses, shown separately for each category of financial assets or financial liabilities;

- Total interest income and interest expense for financial assets and liabilities that are not measured at fair value through profit or loss;
- Interest income on impaired financial assets, calculated at the same rate as was used to calculate the impairment amount; and
- The amount of impairment loss for each category of financial asset.

Other disclosures

Accounting policies As required by IAS 1 *Presentation of Financial Statements*, details of the measurement bases, and other relevant information relating to financial instruments, are to be included in the accounting policies.

Hedge accounting Disclosures are required for each type of hedge accounting used (cash flow, fair value and net investments in foreign operations).

For cash flow hedges, disclosure is required of the periods in which the hedged cash flows are expected to occur and when they are expected to affect profit or loss, and amounts removed from equity in each period (split between amounts included in the income statement and amounts used to adjust the initial carrying value of an asset or liability). In addition, disclosures are required where a hedged forecast transaction is no longer expected to occur and cash flow hedge accounting has been discontinued.

For all hedge accounting relationships, disclosures are required which identify hedge ineffectiveness recorded in profit or loss. These comprise:

- For fair value hedges, gains and losses recorded on both the hedging instruments and the changes in value of the hedged item that are attributable to the hedged risk;
- Hedge ineffectiveness recognised in profit or loss arising from cash flow hedges; and
- Hedge ineffectiveness recognised in profit or loss arising from net investment hedges.

Fair value For each category of financial assets and financial liabilities, fair values are required to be disclosed in such a way that these can be compared with the related book values. There are few exemptions from the scope of IFRS 7, and the required fair value disclosures extend to cover obligations not recognised on balance sheet (such as obligations under operating lease contracts).

The limited exceptions to these fair value disclosures include:

- Where the carrying value is an approximation of fair value (eg short term financial instruments such as trade receivables)
- Investments in equity instruments that do not have a quoted market price in an active market; and

- Insurance contracts which contain a discretionary participation feature if the fair value of that feature cannot be measured reliably.

Where the second and third exceptions above apply and fair value information has not been disclosed, additional information is required to be disclosed to assist the users of the financial statements in making judgements about the extent to which fair values differ from book values.

Nature and extent of risks arising from financial instruments

Both qualitative and quantitative disclosures are required that enable users of financial statements to evaluate the nature and extent of an entity's exposure to financial instruments. These include (but are not limited to) credit risk, liquidity risk and market risk.

Qualitative (narrative) disclosures

For each type of risk arising from financial instruments, disclosure is required of the entity's exposures to risk, and its objectives, policies and processes for managing and measuring that risk. The disclosures include any changes in these factors in comparison to the previous reporting period.

Quantitative (numerical) disclosures

Credit risk disclosures include:

- The maximum exposure to credit risk at the balance sheet date, before taking account of any collateral or other credit enhancements;
- Collateral and credit enhancements held;
- Information about the credit quality of debts that remain within their credit period
- The carrying amount of any assets that would have become impaired, except that their terms have been renegotiated;
- An analysis of the age of assets that are past their due date but have not been impaired; and
- An analysis of assets which individually have been impaired, including the reasons why they have been judged to be impaired.

Liquidity risk disclosures include:

- An analysis of maturities for financial liabilities; and
- A description of how liquidity risk is managed.

Market risk disclosures include:

- A sensitivity analysis. This can take one of two forms. Either an analysis is required to be prepared for each type of market risk to which the entity has exposure at its reporting date or, where an entity already prepares and uses a sensitivity analysis to manage financial risks, it may use that data provided it makes disclosures of how the sensitivity analysis has been prepared and any limitations that might result in it not fully reflecting the fair values of the underlying assets and liabilities.

Amendments to IAS 1 Presentation of Financial Statements

The amendments to IAS 1 add requirements for:

- Objectives, policies and processes for managing capital;
- Quantitative data about what is regarded as capital;
- Whether capital requirements have been complied with; and
- The consequences of any non-compliance which has arisen.

The disclosures include any externally imposed capital requirements and summary data about what is regarded as being capital. This latter disclosure might be required where, for example, certain financial liabilities (eg subordinated debt) are regarded as forming part of an entity's capital or where others, such as components of equity arising from cash flow hedges, are not.

Where an entity operates in a number of different jurisdictions, it may be subject to a number of different regulatory regimes which have differing capital requirements. Where this is the case, and the aggregation of all of the capital disclosures would provide insufficient or distorted information, disclosures are required to be made for each capital requirement to which the entity is subject.

Action required

Companies and other entities that report, or plan to report, in accordance with IFRS should review the new requirements and ensure that they prepare in advance for the additional disclosures. While the effective date is for accounting periods commencing on or after 1 January 2007, comparative information, both numerical and narrative will be required for certain of the disclosures.