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## **IFRS 7 Financial Instruments: Disclosures - A Closer Look**

Muthupandian, K S

The Institute of Cost and Works Accountants of India

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# IFRS 7

## Financial

### Instruments:

### Disclosures

## - A Closer Look

### K.S.Muthupandian\*

The International Accounting Standards Board (IASB) had started out a project to develop an International Financial Reporting Standard (IFRS) on presentation and disclosure in the financial statements of financial institutions and similar entities, with a view to replacing the International Accounting Standard (IAS) 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. However, in late 2002, the IASB made a fundamental change in the direction of this project. On 22 July 2004, the IASB issued the Exposure Draft ED 7 *Financial Instruments: Disclosures*. Then on 18 August 2005 the IASB issued IFRS 7, *Financial Instruments: Disclosures*. The final Standard applies to all entities, financial and non-financial. IFRS 7 replaces and updates the disclosure requirements of IAS 32 *Financial Instruments: Presentation* and supersedes IAS 30. IFRS 7 also extends the scope of many of the disclosure requirements within IAS 30 from banks to all financial institutions. Concurrent with the introduction of IFRS 7, the IASB also amended IAS 1, *Presentation of Financial Statements*, to require disclosures about an entity's capital.

Introducing IFRS 7, Sir David Tweedie, IASB Chairman, said:

*“The Board believes that the introduction of IFRS 7 will lead to greater transparency about the risks that entities run from the use of financial instruments. This, combined with the new requirements in IAS 1, will provide better information for investors and other users of financial statements to make informed judgements about risk and return.”*

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**\*M.Com., AICWA and Member of Tamil Nadu State Treasuries and Accounts Service, presently working as Treasury Officer, Ramanathapuram District, Tamil Nadu. Email: ksmuthupandian@yahoo.co.in**

## Objective

The objective of IFRS 7 is to provide more transparency to financial statement users on an entity's exposure to risks and how those risks are managed.

## Scope

IFRS 7 applies to all IFRS-compliant financial statements that include financial instruments not specifically excluded from the scope of the standard. IFRS 7 applies to all risks arising from all financial instruments, including those instruments that are not recognised on-balance sheet, for all companies in all industries, except those covered by another more specific standard such as interests in subsidiaries, associates and joint venture, post-employment benefits, share-based payment and insurance contracts. For example, loan commitments not within the scope of IAS 39, *Financial Instruments: Recognition and Measurement* are within the scope of IFRS 7. Contracts to buy or sell a non-financial item that are within the scope of IAS 39 (as derivative financial instruments) are also within the scope of IFRS 7. The Application Guidance of IFRS 7 indicates that such financial instruments should be considered a separate class for the purpose of preparing the required disclosures.

The IFRS applies to all entities, including entities that have few financial instruments (e.g., a manufacturer whose only financial instruments are accounts receivable and accounts payable) and those that have many financial instruments (e.g., a financial institution most of whose assets and liabilities are financial instruments).

IFRS 7 introduces:

- requirements for enhanced balanced sheet and income statement disclosure 'by category' (eg, whether the instrument is available-for-sale or held-to-maturity)
- information about any provisions against impaired assets
- additional disclosure relating to the fair value of collateral and other credit enhancements used to manage credit risk
- market risk sensitivity analyses.

## Disclosure Requirements

An entity must group its financial instruments into classes of similar instruments and, when disclosures are required, make disclosures by class.

IFRS 7 requires entities to disclose:

- the significance of financial instruments for an entity's financial position and performance;
- qualitative and quantitative information about the nature and extent of risks arising from financial instruments.

IFRS 7 disclosures must be based on the accounting policies used for the financial statements prepared in accordance with IFRS, including consolidation adjustments. It is possible that the internal information made available to management for risk management purposes is not prepared using such accounting policies, in which case it will need to be adjusted. IFRS 7 repeatedly requires disclosure by 'class' of financial instrument, a group that is appropriate to the nature of the information disclosed and the characteristics of the instruments. A class of financial instrument is a lower level of aggregation than a category, such as 'available-for-sale' or 'loans and receivables'. For example, government debt securities, equity securities, or asset-backed securities could all be considered classes of financial instruments.

The IFRS 7 also requires information about the extent to which the entity is exposed to risks arising from financial instruments, and a description of management's objectives, policies and processes for managing those risks. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create. The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk.

### **Expanded Disclosure of Financial Position and Performance**

IFRS 7 requires greater balance sheet and income statement disclosures, including the following:

- The carrying amount and net gains/losses for each of the categories of financial instruments in IAS 39 (at fair value through P&L, available-for-sale, loans and receivables, etc.)
- Reclassifications of any financial asset as one measured at amortised cost, rather than fair value, or vice versa, and the reasons for such reclassification
- Special disclosures about financial assets and liabilities designated at fair value through profit or loss, including changes in fair value and the portion arising from changes in credit risk
- Financial assets pledged as collateral and financial and non-financial assets held as collateral
- Reconciliation of the allowance for credit losses (bad debts) account
- Interest income and expense for financial assets or liabilities not at fair value through profit or loss
- Impairment losses for each class of financial asset and interest income recognized on impaired financial assets

**Other disclosures**

Examples of other disclosures include:

- the carrying amount of each category of financial instruments recognised by the entity;
- gains and losses recognised for each category of financial instruments recognised by the entity;
- details about financial asset derecognition issues;
- information on financial assets pledged as collateral; and
- an explanation of default and breaches by the entity.

**Fair value disclosures**

IFRS 7 disclosures of accounting policies include requirements related to fair value that previously were included in IAS 32.

The required disclosures include:

- whether the fair value is based on quoted prices or valuation techniques
- whether the fair value is based on a valuation technique that includes assumptions not supported by market prices or rates, and, if so, the amount of the change in fair value recognised in profit or loss that arises from the use of the valuation technique
- the effect of reasonably possible alternative assumptions used in a valuation technique.

**Disclosing Risk “Through the Eyes of Management”**

The IFRS 7 disclosure requirements include both ‘qualitative’ narrative descriptions and specific ‘quantitative’ data about an entity’s exposure to risks arising from the use of financial instruments.

Companies must ‘provide information about the extent to which they are exposed to financial risks, based on information provided internally to the entity’s key management personnel’ – in other words, through the eyes of management.

For each type of risk, disclosure of summary quantitative data, based on information provided internally to key management personnel, as well as any concentrations of risk. Financial risk disclosures include credit risk, liquidity risk and market risk.

**Credit risk**

Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

The minimum disclosures include information on financial assets:

- Maximum exposure to credit risk (without deduction of any collateral held) and any related collateral held
- Information about credit quality of financial assets that are neither past due nor impaired if their terms had not been renegotiated
- Aging analysis of financial assets that are past due but not impaired
- Analysis of financial assets individually determined to be impaired

**Liquidity risk**

Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

The minimum disclosure include: Maturity analysis for financial liabilities showing remaining contractual maturities and a description of the approach to managing liquidity risk.

**Market risk**

Market risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

Currency risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest rate risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Other price risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

The minimum disclosures include:

- A sensitivity analysis for each type of market risk (currency, interest rate, and other price risk) to which the entity is exposed at reporting date. The analysis should demonstrate how profit or loss and equity would have been affected by “reasonably possible” changes in the relevant variable, for example a 100 basis point change in interest rates.
- Methods and assumptions used in preparing the sensitivity analysis and any changes in these from the previous reporting period.

### **Qualitative risk disclosures**

In conjunction with the quantitative disclosures, qualitative disclosures of the following are also required:

- Risk exposures arising from financial instruments
- Objectives, policies and processes for managing the risks and the methods used to measure the risks
- Any changes from the previous reporting period

### **Implementing sensitivity analysis / Value at Risk model**

The requirements are much more onerous and include disclosure of:

- \* The exposures to risk and how they arise;
- \* The objectives, policies and processes for managing the risk and the methods used to measure the risk;
- \* Summary quantitative data about the entity’s exposure to that risk at the reporting date. This disclosure shall be based on the information provided internally to key management personnel of the entity; and
- \* Disclosures about the concentration of risks.

### **Accounting policies**

IAS 1 requires disclosure of a company’s significant accounting policies, including the judgments that management has used in their application. The Application Guidance provides guidance on how these requirements may be applied to financial instruments. It suggests that the disclosures might include the criteria for (1) designating financial assets and financial liabilities as at fair value through profit or loss, (2) designating financial assets as available-for-sale, (3) determining when the carrying amount of impaired financial assets are reduced directly and when the allowance accounted is used, and (4) writing off amounts charged to the allowance account against the carrying amount of impaired financial assets.

## **Implementation plan and Challenges**

An implementation plan that addresses the requirements of IFRS 7 must engage members of the accounting, treasury and regulatory functions and should include:

- understanding the disclosure requirements of IFRS 7 and arrange training for all key stakeholders;
- developing accounting policies on which the IFRS 7 disclosures will be based;
- reviewing existing management reporting systems, policies, procedures, risk frameworks and the nature and extent of quantitative data reported to key management personnel.

One will need to respond to the following challenges:

- will the internal reporting stand up to external scrutiny?
- how does the internal reporting benchmark against other similar entities?
- developing and/or amending existing systems, policies, procedures, risk frameworks and financial reporting processes to support the requirements of IFRS 7;
- developing a draft set of IFRS 7 compliant financial statements and agree the nature and extent of all disclosures with one's auditors; and
- developing and testing the internal controls that support the generation of the disclosures in the annual financial statements (Sarbanes-Oxley Act affected entities will be required to assess the impact of IFRS 7 on their control frameworks).

Some financial instruments, however, may require further disclosures in regards to an entity's exposure to credit risk. For example, the entity may have continuing involvement in transferred financial assets and credit risk exposure may exceed the carrying amount of the continuing involvement asset. Other possible sources of credit risk include credit insurance, collateral, financial guarantees, loan commitments or situations in which netting agreements reduce credit risk exposure of the entity.

## **Effective Date and Transition**

IFRS 7 is effective for annual periods beginning on or after 1 January 2007, with earlier application encouraged, but not required. If an entity applies IFRS 7 for a period beginning before 1 January 2007, that fact should be disclosed. Early adopters are given some relief with respect to comparative prior period disclosures. It should be noted that full comparative financial information will be required in all instances, except for first time adopters of IFRS that adopt IFRS 7 for financial years beginning before 1 January 2006. There are some limited exemptions for current IFRS reporters that early adopt IFRS 7. Advance planning is recommended to ensure full compliance with the extensive disclosure requirements of IFRS 7. Some required disclosures may be considered commercially sensitive. Some of the required information may not be readily available from existing management reporting systems. A number of implementation issues should therefore be addressed well ahead of year-end procedures. IFRS 7 adopted for use in the European Union on 27 January 2006, is now in force, effective for periods beginning on or after 1 January 2007. IFRS 7 has been available for early application in the United Kingdom (UK) for some time, only a few companies chose to adopt it early. IFRS 7 has also been incorporated into UK Generally Accepted Accounting Principles (GAAP) as FRS 29 and needs to be applied by UK companies implementing FRS 26.



## **Concurrent revisions to IAS 1 - Capital Disclosures**

The IASB has also issued a concurrent amendment to IAS 1 requires additional disclosures about the objectives, policies and processes used by the entity to manage its capital. The amendment added requirements for all entities to disclose:

- (a) the entity's objectives, policies and processes for managing capital;
- (b) quantitative data about what the entity regards as capital;
- (c) whether the entity has complied with any capital requirements; and
- (d) if it has not complied, the consequences of such non-compliance.

These disclosures provide information about level of an entity's capital and how it manages capital, which are important factors for users to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events.

## **Conclusion**

As IFRS 7 introduces so many 'extra' disclosure requirements, companies that didn't opt for early adoption should not delay in starting the process. The extent of disclosure, however, will be driven by the entity's extent of use of financial instruments and exposures to risk.

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