Accounting Standards Board

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Stig Enevoldsen
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28 November 2008

Dear Stig

EFRAG's Draft Comment Letter on the IASB's ED 'Improving Disclosures about Financial Instruments'

Thank you for providing the Board with the opportunity to comment on your draft response to the International Accounting Standards Board's (IASB) exposure draft (ED) 'Improving Disclosures about Financial Instruments – Proposed Amendments to IFRS 7'.

The Board has responded directly to the IASB and a copy of our letter is attached.

The Board broadly agrees with the comments EFRAG has made and a number of them underscore the points we have raised in our comment letter to the IASB. In response to the questions you have asked of constituents, we have set out our comments in an attachment to this letter.

However, we do not agree with EFRAG's proposal to extend the disclosure of sensitivity analysis to financial instruments not recognised at fair value. In our view, this imposes an unreasonable burden on preparers and it is not clear the costs involved would outweigh the benefits to users of the financial statements. Accordingly, in the absence of any evidence of either costs or benefits, it is not reasonable to propose a new reporting requirement. We are satisfied that the extensive disclosures already required in IFRS 7 are sufficient in providing users with an understanding of the risks associated with an entity holding financial instruments. For those reasons, we would strongly urge EFRAG not to put forward this proposal in its submission to the IASB.

Should you have any queries regarding our response please contact me, or Mario Abela, Project Director, on +44 207 492 2442 or by email m.abela@frc-asb.org.uk.

Yours sincerely

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Detailed Responses to Questions

Question for EFRAG's constituents Some members of EFRAG's User Panel suggested that the proposed additional sensitivity disclosures, which the ED proposes should apply only to those instruments measured at fair value, should also apply to instruments that are not recognised in the statement of financial position and to instruments that are recognised in the statement of financial position but not measured at fair value. In their view, the proposed disclosures make fair value information more useful, regardless of whether the fair value appears in the statement of financial position or in the notes (as would be the case for instruments not recognised in that statement and instruments measured at amortised cost). However, some EFRAG members believe that the benefit of such additional disclosure would not justify its cost. EFRAG would particularly welcome constituents' views on this issue.
ASB Comment We accept that some users may find useful additional information conveyed in a sensitivity analysis for financial instruments that are not recognised at fair value and have effectively been marked-to-model (ie where significant inputs to the fair value measurement for disclosure purposes have relied on data that is not drawn from observable market data). However, there are several reasons why we do not support this proposal: • If a financial asset or liability is not recognised at fair value the rationale in IAS 39 'Financial Instruments: Recognition and Measurement' is that there is a reasonable basis for carrying that item (eg loans and receivables) at some other amount. Some may not agree with that but it is the basis on which the IFRS reporting framework currently recognises and measures financial instruments. The objective of IFRS 7 is not to impose a fair value measurement on those financial assets and liabilities but through disclosure to assist users to understand the "significance of financial instruments for an entity's financial position and performance" and the attendant risks associated with holding those instruments. IFRS 7, paragraph 31, already requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments. Those requirements include both quantitative and qualitative disclosures. In our view, sensitivity analysis is aimed at addressing questions about various types of risks. Accordingly, it is not clear to us that disclosure of sensitivity analysis for financial instruments not recognised at fair value is necessarily the most effective manner in which to communicate the nature and extent of risks to users of

the financial statements.

- We have serious concerns, consistent with some of EFRAG's members, that there is no demonstrable evidence that the benefits of such a disclosure requirement outweigh the costs of producing it. In the absence of understanding the nature of the costs and benefits associated with providing sensitivity analysis for financial instruments that are not recognised at fair value and employ mark-to-model valuation, we are not convinced this should be put forward as a proposal. If, on balance, EFRAG decides to put this proposal forward to the IASB we would strongly suggest some preliminary field testing is carried out. This field testing should be undertaken with some financial institutions in Europe to test the practicality and usefulness of requiring such information to be disclosed as they are likely to be the types of entities that are most affected by such a requirement. It will also be useful to demonstrate how the information that results from such disclosure contributes to satisfying the overall objective of IFRS 7.

Question for EFRAG's constituents

As the table above shows, the proposal is that a contractual maturity analysis should still be provided for non-derivative financial liabilities, but not for derivatives. EFRAG has discussed this issue at length, and members have differing views:

- Some EFRAG members believe that contractual maturity analyses provide useful information that helps users to understand what the worst-case scenario could be should expectations about maturity change. In their view, this is the case regardless of whether the liability is a derivative or a non-derivative.
- Some EFRAG members believe that a contractual maturity analysis for derivative instruments usually has too little information value to be a required disclosure. In their view, the ED was right in proposing to still require a contractual maturity analysis for non-derivative financial liabilities but not for derivatives.
- Some EFRAG members do not believe that the case for treating derivatives and non-derivatives differently has been made; either a contractual maturity analysis is useful and should be required in both cases, or it is not sufficiently useful and should be required in neither case.

EFRAG would particularly welcome constituents' views on this issue.

ASB Comment

The ASB preliminary view on this issue is that the disclosure of information about contractual maturities for derivative financial liabilities is likely to be useful to users of the financial statements even where an

entity does not manage liquidity risk on that basis. We note that there may be instances where the amount at which management expects to settle a financial liability may not be realistic and it is therefore useful to disclose the amount at which the entity is contractually obliged to settle the liability. We believe that both amounts are particularly relevant to users and the qualitative description required by paragraph 39(c) provides the basis for management to explain any difference between those two amounts and how the entity is managing that exposure.

However, we note that in the IASB's review of the implementation of IFRS 7, preparers raised concerns about the practicality and relevance of contractual maturities where an entity does not manage liquidity risk on that basis – and many commented that they did not manage on that basis. Similarly, we think it is important to test our working assumption that users will find both sets of information relevant. For those reasons, in our Financial Reporting Exposure Draft we have asked UK constituents whether they are satisfied that these additional disclosure requirements are justified.

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International Accounting Standards Board
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28 November 2008

Dear Sirs

Exposure Draft of proposed amendments to IFRS 7 'Financial Instruments: Disclosures'

The ASB is responding to the Exposure Draft (ED) 'Improving Disclosures about Financial Instruments: Proposed Amendments to IFRS 7'. The ASB's responses to the questions asked in the ED are set in an Appendix to this letter.

The ASB fully supports the IASB's objective to improve the information provided about financial instruments to enable users to form judgements about their potential implications on an entity's financial position and performance. The proposed amendments will also serve to address some of the issues preparers have raised about the practicalities of applying IFRS 7. Present market conditions have highlighted the importance of relevant and reliable information about financial instruments.

The ASB is concerned that not requiring disclosure of contractual maturities may lead to a loss of information which is useful to users of the financial statements. Our working assumption is that users are keen to understand an entity's maximum exposure arising from a derivative financial liability, in addition to management's expectations about its settlement value. For that reason, in our Financial Reporting Exposure Draft, we have invited UK constituents to comment on whether additional disclosure of contractual maturities is warranted where an entity does not manage liquidity risk on that basis.

Should you have any queries regarding our response please contact me or Mario Abela, Project Director, on 020 7492 2442 or by email m.abela@frc-asb.org.uk.

Yours sincerely

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Appendix – Response to Invitation to Comment

Fair Value Disclosures

Question 1

Do you agree with the proposal in paragraph 27A to require entities to disclose the fair value of financial instruments using a fair value hierarchy? If not, why?

ASB response:

We support the proposal to introduce a fair value hierarchy as it should improve the ability of users to assess the decision-usefulness of information disclosed about the fair value of financial instruments.

Question 2

Do you agree with the three-level fair value hierarchy as set out in paragraph 27A? If not, why? What would you propose instead, and why?

ASB response:

We support the introduction of a three-level hierarchy.

However, it is not clear to us what is required in terms of assessing a "significant input" for the purposes of fair value hierarchy (last two sentences in paragraph 27A). The issue is about what reference point to use to make assessments of "significance". We think that "significant to the fair value measurement in its entirety" can be interpreted in a number of ways, given the absence of guidance which accompanies that phrase in SFAS 157.

For that reason, we believe that paragraph 27A needs to be expanded to explain that "significance" relates to the importance of the input to the pricing of a financial instrument rather than the materiality of its effect on the value of a class of instruments as a whole. In the case of equity instruments where there is an observable market price, the fair value measurement clearly falls within Level 1 of the hierarchy. For pricing a share option, a valuation technique may need to be employed where:

(a) all significant inputs are based on observable market data (Level 2); or
(b) one or more significant inputs are not based on observable market data (Level 3).

This distinction is made in the table at paragraph IG13A but as it is so fundamental to applying the hierarchy, it should be explained within the Application Guidance.

It would also be useful to remove the circular reference: "…a significant input is an input that is significant". We would suggest the following wording "…a significant input is determined by reference to its importance and impact in the determining the fair value of a financial instrument".

Question 3

Do you agree with the proposals in:

(a) paragraph 27B to require expanded disclosures about the fair value measurements recognised in the statement of financial position? If not, why? What would you propose instead and why?

(b) paragraph 27C to require entities to classify, by level of the fair value hierarchy, the disclosures about the fair value of the financial instruments that are not measured at fair value? If not, why? What would you propose instead, and why?

ASB response:

We broadly support the expanded disclosures.

However, as part of the FRC's research and consultation with UK constituents for its Complexity of Corporate Reporting Project, some have raised concerns about the disclosure requirements in IFRS 7. In particular, we are not convinced that materiality is applied consistently to these disclosures. As a result, we have observed extensive disclosures in financial reports for non-material financial instrument exposure.

We note that the Implementation Guidance to IFRS 7 at paragraphs IG3-4 restates the definition of materiality from IAS 1 but it does not offer guidance on applying that overall principle to IFRS 7. We accept that the application of materiality is a matter of judgement, based on facts and circumstances, but it would be useful for the IASB to provide some guidance on how to relate that principle to the objective of IFRS 7. In our view, such clarification could be achieved by inserting a paragraph after IG2 that relates the point about coherence between disclosures to the role of qualitative characteristics (including materiality) in guiding that judgement.

Liquidity risk disclosures

Question 4

Do you agree with the proposal in paragraph 39(a) to require entities to disclose a maturity analysis for derivative financial liabilities based on how the entity manages liquidity risk associated with such instruments? If not, why? What would you propose instead, and why?

ASB response:

We support the proposal to disclose expected maturities of derivative financial liabilities on the basis that it will provide insights to users about how management manages liquidity risk. However, we also consider contractual maturities to be relevant to users in providing a 'worst case' position of what an entity is contractually bound to settle at. The absence of information about remaining contractual maturities may impair users' understanding of liquidity risk. Where markets are fluctuating and unstable, management's expected values may be unrealistic and, therefore, in the interests of transparency, information about maximum exposure may be of particular relevance. We note that in the IASB's discussions with constituents on the implementation of IFRS 7, this was raised as one of the problem areas. For that reason, we have asked, in our Invitation to Comment, whether UK constituents believe it is warranted to require both expected and contractual maturities to be disclosed for derivative financial liabilities.

Although our comment period does not close until 30 January 2009, we would be willing to share the feedback we receive from constituents on this issue if you consider that helpful.

Question 5

Do you agree with the proposal in paragraph 39(b) to require entities to disclose a maturity analysis for non-derivative financial liabilities based on remaining expected maturities if the entity manages the liquidity risk associated with such instruments on the basis of expected maturities? If not, why? What would you proposed instead, any why?

ASB response:

We support the proposed disclosure of maturities for non-derivative financial liabilities.

Question 6

Do you agree with the amended definition of liquidity risk in Appendix A? If not, how would you define liquidity risk, and why?

ASB response:

We support the amended definition of liquidity risk.

We note that paragraph B11E (Application Guidance) states that "if appropriate, the entity shall disclose a maturity analysis of financial assets it holds for managing liquidity risk". In our view, the IASB should make clear that in satisfying the requirements of paragraph 39(c) the overriding principle is to provide users with an understanding of *how the entity* manages liquidity risk – that is likely to involve both quantitative and qualitative information. If an entity manages it on the basis of expected maturities then presentation of financial liability and financial asset maturities is relevant and should be disclosed. However, where an entity manages liquidity risk on a net basis, information on that net position may also be useful for users in understanding and forming judgements about the strength of those management approaches. There is a danger that the requirements of paragraph 39(c) can be interpreted too narrowly and fail to provide users with sufficient information to enable them to understand how the entity manages liquidity risk.

Accordingly, we would suggest that the IASB makes two changes:

(i) Paragraph 39(c) needs to be expanded to reflect not just a "description" but other relevant information to assist users to understand how liquidity risk arising from financial instruments is managed (which is consistent with the overall objective of this section of the Standard as set out in paragraph 31); and

(ii) the emphasis of B11E should be to expanded to explain the types of both quantitative and qualitative information that may be relevant to enhancing users' understanding of an entity's liquidity risks.

Effective date and transition

Question 7

Do you agree with the proposed effective date? If not, why? What would you propose instead and why?

ASB response:

We support the proposed effective date.

Question 8

Are the transition requirements appropriate? If not, why? What would you propose instead and why?

ASB response:

We support the proposed transition requirements.