EFRAG
European Financial Reporting Advisory Group

The costs and benefits of implementing of the Amendment to IFRS 7 *Improving Disclosures about Financial Instruments*

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IFRS 7 *Improving Disclosures about Financial Instruments* (the Amendment).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A summary of the Amendment

4 The objective of IFRS 7 *Financial Instruments: Disclosures* is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

5 The Amendment amends and adds to the existing disclosure requirements. It does so in response to the demand from users for enhanced disclosures on financial instruments, primarily in the light the current market conditions. These enhanced disclosures cover two topics: fair value measurement and liquidity risk.

Fair value measurement

6 Existing IFRS 7 already requires entities to provide some information about their use of fair value measures. The Amendment adds to those requirements by requiring entities to classify the fair value measures they use into three levels (the fair value hierarchy) and to provide additional information on each measure used depending on its level.

7 The levels of the fair value hierarchy depend on the type of input used for the valuation of those instruments. There are three levels:

(a) quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);

(b) inputs other than quoted prices included under Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

(c) inputs for the asset or liability that are not based on observable market data (unobservable input) (Level 3).

This hierarchy is similar to the one used for similar purposes in US GAAP.

8 The additional disclosures to be provided are:

(a) an analysis of the fair value amounts used by level;

(b) any significant transfers between Level 1 and Level 2, and the reasons for those transfers;

(c) for Level 3 valuations, an analysis of the movement between the opening and closing balances disclosing separately various prescribed items (such as total gains and losses recognised in profit or loss, total gains and losses recognised in other comprehensive income, transfers into and out of Level 3, etc); and

(d) for Level 3 valuations, certain information about the sensitivity of the fair value amounts.

Liquidity risk

9 Existing IFRS 7 requires disclosure of a maturity analysis of all financial liabilities by reference to the contractual cash flows. The Amendment changes the requirement for derivative financial liabilities by allowing management to use a different approach unless the contractual maturities are essential for an understanding of the timing of the cash flows associated with those instruments.

EFRAG's initial analysis of the costs and benefits of the Amendment and stakeholders' views on it

10 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users both in year one and in subsequent years from implementing the Amendment in the EU. The tentative conclusions reached as a result of that initial assessment were that:

(a) for some preparers, the additional year one and ongoing costs of implementing the Amendment are likely to be insignificant. For some other preparers, the ongoing costs are likely to be greater than that;

(b) it is unlikely that the Amendment will result in an increase in the costs users will incur;

(c) the benefits arising from the implementation of the Amendment are likely to be significant; and

(d) those benefits are likely to exceed the costs involved.

11 EFRAG published its initial assessment and supporting analysis on 3 April 2009. It invited comments on the material by 15 May 2009. The results of this consultation can be summarised as follows. Where specific responses to the questions posed were provided by respondents:

(a) All respondents agreed with EFRAG's assessment of the costs involved for users and preparers.

(b) All respondents agreed with EFRAG's assessment of the benefits associated with implementing the Amendment.

(c) All respondents agreed with EFRAG's assessment that the benefits to be derived from application of the Amendment are likely to exceed the costs involved.

EFRAG's final analysis of the costs and benefits of the IFRS 7 Amendments

12 Based on its initial analysis and on stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of implementing the Amendment in the EU is presented in the paragraphs below.

Cost for preparers

<u>Fair value measurement disclosures</u>

13 EFRAG's assessment is that the Amendment could involve preparers in additional costs in two areas:

(a) Breaking down the fair value measurement disclosures into the three levels. EFRAG's assessment is however that the information necessary to meet these requirements already exists and therefore the cost of meeting the new requirements—which would be an ongoing cost—is likely to be insignificant in most cases, because it can be collected through existing reporting systems.

(b) Preparation of the reconciliation from the opening balance to the closing balance of Level 3 fair value measurements and disclosure of specific information on the movements in the period. EFRAG understands that implementing these reconciliation requirements could require preparers to monitor a large quantity of additional information, such as the purchases and sales of assets measured using Level 3 techniques within a specific book of business. When the number of corresponding books of business is large and spread among various subsidiaries, this ongoing cost would not be insignificant.

<u>Liquidity risk disclosures</u>

14 The existing requirements concerning liquidity risks disclosures require entities to provide specific disclosures on liquidity risk for all financial liabilities. As previously explained, under the Amendment an entity is no longer required to provide a maturity analysis on liquidity risk that includes the remaining contractual maturities for derivative financial liabilities, unless such information is essential to the understanding of the cash flows associated with the instruments. Therefore, EFRAG's assessment is that this part of the Amendment will have no cost implications.

<u>Overall assessment</u>

15 EFRAG's overall assessment is that, for some preparers, the additional year one and ongoing costs of implementing the Amendment is likely to be insignificant, but for some other preparers the ongoing costs are likely to be greater than that (mainly because of the costs involved in disclosing a reconciliation of the opening to closing balance Level 3 fair value measures).

Costs for users

16 EFRAG is not aware of any aspect of the Amendment that will increase the costs users incur in analysing the financial statements as a result of its adoption.

Benefits of the Amendment

17 In issuing the Amendment, the IASB is responding to a strong and urgent call from users for better disclosures about the use of, and uncertainties arising from, fair value measures of financial instruments and about the liquidity risk to which the entity is exposed and how it is managing that risk. The value of some of the fair value measurement disclosures is highlighted by the fact that some entities already provide some of the information required by the Amendment on a voluntary basis.

18 EFRAG's assessment is that the Amendment will improve the quality of the information provided in two areas where such improvements are much needed. The benefits arising from the implementation of the Amendment are therefore likely to be significant.

Conclusion

19 To summarise, EFRAG believes that for some entities implementation of the Amendment will result in some not insignificant ongoing costs. On the other hand, the benefits are likely to be significant and therefore to exceed the costs involved.

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