EFRAG
European Financial Reporting Advisory Group

12 December 2008

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir/Madam

Exposure Draft of proposed amendments to IFRS 7

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Improving disclosures about financial instruments (Proposed amendments to IFRS 7)*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

Our detailed comments on the ED are set out in the appendix to this letter. To summarise, we agree with most of the proposals related to fair value measurements, but we would like to draw the IASB's attention to the ramification of the proposed definitions of levels 1, 2 and 3. Regarding liquidity risk, although we broadly support the proposed changes, we think liquidity risk is a subject worthy of more extensive study in the future.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Emmanuel Gagneux or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix — Responses to the invitation to comment

Fair value measurements

Question 1: Use of a fair value hierarchy—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?

1 EFRAG agrees with the proposal. In our view, the use of this hierarchy would help users to assess the reliability of the fair value measurements by providing information about the content of valuation techniques in terms of the judgments and assumptions used.

Question 2: Proposed three-level hierarchy—Do you agree with the three level hierarchy as set out in paragraph 27A? If not, why? What would you propose instead and why?

2 EFRAG agrees with the principle of a three level hierarchy. However, EFRAG believes that the proposed definitions raise two issues.

3 The first issue concerns the provisions in IAS 39 related to the refutation of transaction price by a valuation technique in determining the fair value, which leads to the recognition of a so-called "day-1" gain or loss. Paragraph AG 76 of IAS 39 states that a transaction price can only be refuted by observable current market transactions in the same instrument or by a valuation technique whose variables include *only* data from observable markets[1]. By contrast, the proposed level 2 definition includes "quoted prices for similar instruments or other valuation techniques for which *all significant inputs* are based on observable market data". Thus, the day-1 gain or loss is recognised when evidenced by a valuation technique whose inputs are *only* observable market data, while the level 2 category includes valuation techniques whose *significant inputs* are observable market data.

4 Accordingly, EFRAG believes that the line permitting day-1 gain or loss recognition runs through the middle of the level 2 category. We do not think this is appropriate; in our view the two sets of requirements should be aligned, and our suggestion is that this should achieved by moving the day-1 profit line so that it coincides with the border between level 2 and level 3. We therefore propose that the IASB amend IAS 39 by replacing the expression "valuation technique whose variables include only data from observable markets", in paragraph AG 76 of IAS 39, by the expression "valuation techniques for which all significant inputs are based on observable market data".

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[1] **IAS 39 paragraph AG76 :**
"Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets."

5 The second issue concerns the status of data observed from markets that are not active.

(a) Paragraph 28 of FAS 157 states that quoted prices for identical or similar instruments in markets that are not active belong to the level 2 category[2].

(b) The proposed definition of level 2 under IFRS 7 comprises "quoted prices for similar instruments or other valuation techniques for which all significant inputs are based on observable market data". However, it is unclear whether "observable market data" is intended to mean "observable data in an active market".

(c) On the other hand, the IASB has recently issued educational guidance on fair value measurements supporting the fact that valuation techniques incorporating significant unobservable inputs might be, in certain cases, more relevant than valuation techniques based on data observed in inactive markets[3].

(d) However, the combination of the definition of level 2 under US GAAP (which in practice is often used as accounting guidance for interpreting IFRS) with the language of the proposed definition for level 2 might indicate that valuation techniques based on observable data in inactive markets are to be included in IFRS 7's level 2 category. Since the IASB guidance suggests that such valuation techniques might be, in certain circumstances, less relevant than valuation techniques incorporating significant unobservable input (which clearly pertain to the level 3 category), we believe that valuation techniques based on observable data in inactive markets should belong to the level 3 category as well (in order to avoid situations where a level 3 valuation technique might be more relevant than

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[2] **FAS157 paragraph 28:**
"Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:
a. Quoted prices for similar assets or liabilities in active markets
b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)
c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)."

[3] IASB educational guidance on fair value measurement : *Using judgement to measure the fair value of financial instruments when markets are no longer active*, Paragraph 15:
"In some cases, using unobservable inputs might be more appropriate than using observable inputs. In other words, an entity uses observable transaction prices to the extent they represent the fair value of the instrument. If they do not represent the fair value of the instrument, and significant adjustments need to be made to the observable transaction prices, it might be more appropriate for the entity to use a valuation technique based on unobservable inputs. For example, even when an observable transaction price is available, an entity might need to make significant adjustments to that transaction price because the observable transaction price is not current. Those adjustments might be necessary to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. When significant adjustments are required to available observable inputs it might be appropriate to utilise an estimate based primarily on unobservable inputs. This is commonly referred to as 'mark-to-model'. The determination of fair value often requires significant judgement."

a level 2 valuation technique). Therefore, we recommend that the IASB modify the level 2 definition accordingly.

Question 3: Required disclosures—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?*

6 EFRAG agrees in principle with the proposed disclosures about the fair value measurements of instruments that both are, and are not, recognised in the statement of financial position; we think users will find this information useful. On the other hand, we are concerned that there may be practical difficulties in implementing the requirement of paragraph 27 B (c) of the exposure draft, particularly when derivative instruments with daily settlements are involved.

7 In addition, we think it would be useful to require the disclosures about the three measurement levels to be linked with the line items of the statement of financial position, that is to say, to provide a break-down of each fair value level by line item (or vice versa).

Liquidity risk

Question 4: Maturity analyses—Do you agree with the proposal in paragraph 39(a) to require entities to disclose a maturity analysis based on how the entity manages the liquidity risk associated with such instruments? If not, why? What would you propose instead, and why?

and

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 propose instead, and why?

8 The changes proposed are summarised in the table below:

Type of financial instrument	Current IFRS 7	Proposed amended IFRS 7
Non-derivative liabilities	Contractual maturity analysis	Contractual maturity analysis and expected maturity analysis
Derivative liabilities	Contractual maturity analysis	Maturity analysis based on liquidity risk management

9 EFRAG understands that most reporting entities do not manage the liquidity risk associated with financial liabilities on the basis of contractual maturities and therefore agrees that liquidity risk disclosures based on how liquidity is managed (including expected maturity) should be provided.

10 However, EFRAG does not think that there is a clear basis for distinguishing between derivative and non-derivative financial liabilities with regard to liquidity risk. Accordingly, the same disclosures should be applied to both. As we are unconvinced about the usefulness of contractual maturity analyses when the reporting entity does not manage its liquidity risk on such basis, we recommend that this requirement be deleted for non-derivative liabilities, thus bringing the requirements for derivative financial liabilities into line with those for non-derivative financial liabilities.

11 EFRAG believes that a liquidity risk disclosure that focuses just on the liabilities does not give a complete view of the liquidity position of an entity. In our view the analysis should include the financial assets (including guarantees and commitments received) that the entity could use in response to a liquidity shortage. EFRAG is aware that the proposed amendment contains a provision requiring the disclosure of such information "if appropriate" (in paragraph B11E of the application guidance); but we think that the statement in B11E should be moved from the application guidance to the main body of the proposed standard to give equal emphasis to the treatment of assets and liabilities.

12 Subject to the above comments, we support the proposals on liquidity risk disclosures. However, EFRAG thinks that liquidity risk is key factor of an entity's financial stability, but it is also a complex matter which is difficult to encapsulate in simple quantitative disclosures. Therefore, although we think maturity analyses provide some information about liquidity risk, we think they tell only part of the story and that, if the disclosures are to be comprehensive, information might also be needed about:

(a) The liquidity of the assets; for example, whether assets can be easily sold or refinanced in order to raise funds. This may depend, for example, on the nature of the asset, on its credit worthiness, on the characteristics of the market in which it is negotiable and on its eligibility to certain sources of refinancing (central bank refinancing, revolving securitization structures …).

(b) The stability and the diversification of the sources of funding, including the regular sources (deposits, inter-bank market, securitization markets…) and the potential sources resulting from the occasional sale or refinancing of assets.

(c) Whether the entity liquidity buffers would be sufficient to face the occurrence of a stress scenario.

13 As a result, EFRAG thinks the IASB should consider the need for a more extensive piece of work on liquidity risk as a separate agenda item in the medium term. Perhaps some sort of research study could be carried out on the subject.

Question 6—Do you agree with the amended of liquidity risk in Appendix A? If not, how would you define liquidity risk, and why?

14 The proposal is that the words "that are settled by delivering cash or another financial asset" shall be added to the end of the existing liquidity risk definition ("the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities") to make it clear that financial liabilities that will be settled by the entity's own equity

instruments or by the transfer of non-financial assets do not fall within the scope of the liquidity risk disclosures in paragraph 39.

15 EFRAG agrees that such liabilities should not be dealt with in the paragraph 39 disclosure.

Question 7: Effective date—Do you agree with the proposed effective date? If not, why not? What would you propose instead, and why?

and

Question 8: Transition—Are the transition requirements appropriate? If not, why? What would you propose instead, and why?

16 The ED proposes that amendments shall be applied from 1 July 2009, with early adoption permitted.

17 Our general view is that the IASB, when setting effective dates and transition arrangements, should allow sufficient time for jurisdictions with endorsement procedures to endorse the IFRS and remain on full IFRS.

18 On the other hand, we recognise that these changes are urgently needed and accept the short lead time in this particular case. However, earlier in this letter we expressed concern about the practicability of one of the disclosures. It might be that some of the practicability issues could be resolved if the lead time was longer.

19 Subject to the above, EFRAG agrees with both the proposed effective date and the transition requirements.

Drafting comments

20 EFRAG understands that the intention is that:

(a) paragraph 27B (b)(i) would require the disclosure of total gains and losses for the period (realised and unrealised) recognised in profit or loss for instruments that are measured using a level 3 valuation technique.

(b) paragraph 27B(c) would require the same information but only for unrealised gains.

21 EFRAG would like to draw the attention of the IASB to the confusion that might result from the language used in paragraph 27B(c):

(a) The use of the word “amount” in the expression “the total amount of unrealised gains or loss” in the first sentence of 27B (c), which does not appear in 27B (b)(i), might suggest that the information required in each case is of a different nature.

(b) The use of the expression “for those assets and liabilities that are still held at the end of the reporting period” seems redundant bearing in mind that the required information relates to unrealised gains or losses.