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Proposals to improve disclosures about financial instruments

On 15 October 2008, the IASB published for comment proposed amendments to IFRS 7 **Financial Instruments: Disclosures** in its Exposure Draft (ED) **Improving Disclosures about Financial Instruments**.

The ED is a further response by the IASB to requests from constituents to improve disclosures about financial instruments in the light of current market conditions, particularly as regards fair value measurements and liquidity risk.

The IASB has requested comments on the proposals by 15 December 2008 (not allowing the usual 120-day comment period).

Fair value disclosures

With limited exceptions, IFRS 7.25 requires disclosures about fair value for each class of financial assets and financial liabilities (whether or not they are measured at fair value in the statement of financial position). In order to improve these disclosures, the proposals make use of a three-level fair value hierarchy comparable to that set out in the US standard, SFAS 157 **Fair Value Measurements** (see Table 1 overleaf). Entities would be required to analyse their financial instruments using this hierarchy.

Additional disclosure requirements are proposed for classes of financial instruments measured at fair value in the statement of financial position, and these are set out in Table 2 overleaf. In addition, for financial instruments or classes of financial instruments **not measured** at fair value (i.e. instruments categorised as 'held-to-maturity', 'loans and receivables' or 'other liabilities'), entities would be required to analyse the fair values disclosed for such instruments in accordance with the three-level hierarchy (but would not be required to provide the other disclosures set out in Table 2).

Liquidity risk disclosures

The second part of the ED proposes improvements to the liquidity risk disclosures required by IFRS 7.39 (see page 3 for details).

Table 1. Proposed fair value hierarchy

Level	Fair value determination
1	Quoted prices in active markets for the **same** instrument (i.e. without modification or repackaging).
2	Quoted prices in active markets for **similar** assets or liabilities or other valuation techniques for which a**ll** significant inputs* are based on observable market data.
3	Valuation techniques for which **any** significant input is **not** based on observable market data.

*The ED defines 'significant input' as being significant in the context of the fair value measurement in its entirety. It also states that the assessment of significance of a particular input requires judgement.

Table 2. Disclosures required for each class of financial instruments carried at fair value

1) The level in the fair value hierarchy into which the fair value measurements are categorised.
2) For any class of financial instruments that uses level 3 valuation techniques, a reconciliation from the beginning balances to the ending balances, to include separate disclosure of:
    a) total (realised and unrealised) gains or losses recognised in profit or loss for the period (and where they are presented within the statement of comprehensive income);
    b) total gains or losses recognised in other comprehensive income;
    c) purchases, sales, issues and settlements (net); and
    d) transfers into/out of level 3 (e.g. transfers attributable to changes in the observability of market data).
3) The total amount of unrealised gains or losses included under 2(a) above for those instruments still held at the end of the reporting period, and a description of where those unrealised gains or losses are presented in the statement of comprehensive income.
4) For fair value measurements using level 3 valuation techniques, if changing one or more of those inputs to reasonably possible alternative assumptions would change fair value significantly:
    a) that fact; and
    b) the effect of those changes for each class of financial instruments.

    For this purpose, significance would be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, total equity.
5) Any movements between the levels of the fair value hierarchy (in addition to those disclosed under 2(d) above).
6) The reasons for all movements between any levels of the hierarchy.

These disclosures would be presented in a tabular format unless another format was more appropriate. Also, an entity would be required to disclose other information to enable users to evaluate the quantitative information disclosed. An example of such additional disclosure would be information about instruments in one level of the hierarchy that are hedged by instruments from another level (e.g. an unquoted bond (level 2) is hedged by a quoted interest rate swap (level 1)).

An illustrative example of the disclosures proposed in (1) to (3) in Table 2, reproduced from the ED, is set out in the appendix to this newsletter.

Clarification of scope of liquidity risk disclosures

Firstly, the proposals aim to clarify the scope of items to be included in the maturity analysis required by IFRS 7.39 by amending the definition of liquidity risk to include only financial liabilities that are settled by delivering cash or another financial asset. This would result in the exclusion of financial liabilities that will be settled in an entity's own equity instruments and contracts over the receipt or delivery of non-financial items that fail the 'own use' –exemption in IAS 39.5-7. Under the proposals, guidance would be added to clarify that any hybrid contract (i.e. a contract that contains one or more embedded derivatives) should be treated as a non-derivative financial liability, so the embedded derivative(s) would not have to be separately included in the maturity analysis.

Expansion of maturity analysis

The ED also proposes to expand the maturity analysis, focusing more on the way an entity manages liquidity risk, and distinguishes between derivative and non-derivative financial liabilities. Originally, IFRS 7 only acknowledged that entities might also wish to disclose an additional maturity analysis based on the way they manage liquidity risk. The proposals would require an entity to disclose:

- for derivative financial liabilities (including unrecognised derivative financial liabilities), a maturity analysis based on either expected or contractual cash flows depending on how an entity manages its liquidity risk arising from such instruments; and
- for non-derivative financial liabilities, as a minimum, a maturity analysis based on contractual maturities. If the entity manages its liquidity risk associated with such instruments based on expected maturities, an entity would also be required to provide an analysis based on remaining expected maturities.

Strengthening the relationship between qualitative and quantitative disclosures

To enhance the relationship between quantitative and qualitative disclosures for liquidity risk, the ED proposes to require explanation of how estimates in the maturity analyses are determined (e.g. how the expected maturities are established). If outflows in the maturity analyses could occur significantly earlier than indicated or at significantly different amounts the entity would be required to state that fact along with quantitative information that would allow users to evaluate the extent of such risks.

The ED also proposes additional guidance on the application of the requirements in IFRS 7.39 in specific circumstances in Appendix B to IFRS 7.

Effective date and transition

The ED proposes an effective date of 1 July 2009. Earlier application would be permitted provided that this fact was disclosed. In the absence of specific transitional provisions, the amendments would be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Appendix

The examples below are reproduced from the Illustrative Examples set out in the ED.

Disclosures of fair values in accordance with the fair value hierarchy

		Assets measured at fair value		
		Fair value measurement at end of the reporting period based on:		
		quoted prices in active markets for the same instrument (Level 1)	valuation techniques for which all significant inputs inputs are based on observable market data (Level 2)	valuation techniques for which any significant input is not based on observable market data (Level 3)
Description	**31 Dec 20X2**	**CU million**	**CU million**	**CU million**
Financial assets at fair value through profit or loss	60	25	15	20
Available-for-sale financial assets	75	65	–	10
Total	135	90	15	30

Assets measured at fair value based on valuation techniques for which any significant input is not based on observable market data (Level 3)

	Fair value measurement at reporting date		
	Financial asset at fair value through profit or loss	**Available-for-sale financial assets**	**Total**
	CU million	**CU million**	**CU million**
Beginning balance	14	11	25
Total gains or losses			
in profit or loss	11	(3)	8
in other comprehensive income	4	–	4
Purchases, issues and settlements (net)	(7)	2	(5)
Transfers into/out of level 3	(2)	–	(2)
Ending balance	20	10	30
Total unrealised gains or losses for the period included in profit or loss for assets held at the end of the reporting period	7	–	7

Gains or losses (realised and unrealised) included in profit or loss for the period are presented in trading income and in other income as follows:

	Trading income	**Other income**
	CU million	**CU million**
Total gains or losses included in profit or loss for the period	11	(3)
Change in unrealised gains or losses for assets held at the end of the reporting period	7	–

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