COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CESR STATEMENT

Application of Disclosure Requirements Related to Financial Instruments in the 2008 Financial Statements

Executive Summary

The financial crisis has had a major impact on the financial position and performance of publicly traded companies, particularly those in the financial sector. Strengthening investor confidence requires improved transparency on the actual situation of financial companies. A key role for CESR is to monitor the application of accounting requirements under International Financial Reporting Standards (IFRSs). In the current context of market turbulence a particular area of interest is the information provided on the treatment of financial assets and liabilities.

CESR has analysed 96 European listed banks and/or insurers, including 22 companies from the FTSE Eurotop 100 index. CESR believes that the largest financial companies have their financial statements subjected to the highest level of scrutiny. The companies' financial statements were reviewed solely to allow CESR to perform an analysis of how the detailed requirements of IFRS 7 – *Financial Instruments: Disclosures* and certain related guidance had been applied.

The results of CESR's analysis show that in some areas a significant proportion of European financial companies failed to comply with mandatory disclosure requirements relating to financial instruments. CESR believes that this information is key to understand a company's financial position and performance and that its omission could consequently affect the ability of investors to make decisions regarding their investment.

CESR would have expected a higher level of compliance with mandatory requirements, particularly in light of the market conditions that existed during the second half of 2008 and the beginning of 2009.

At the same time, CESR notes that a significant number of companies provided additional disclosures in line with the recommendations that were published in late 2008, which is to be welcomed.

CESR's analysis deals with the application of the mandatory disclosure requirements of IFRS 7 – *Financial Instruments: Disclosures* and with additional recommendations and guidance on disclosures that have been issued by a number of interested parties namely the reports of the IASB Expert Advisory Panel, the Financial Stability Forum, the Senior Supervisors Group and CESR's statement, all published in late 2008. Some of that material is, or is in the process of becoming, integrated into IFRS disclosure requirements. Consequently, although some of the material concerned was only providing additional guidance on those requirements that already existed for 2008 year-ends, it should be noted that such material was not actually mandatory at the point the accounts reviewed by CESR were produced. The analysis makes a distinction between the degree of fulfillment of mandatory requirements from that related to complementary guidance. The analysis has focused on compliance with the selected disclosure requirements or recommendations; the actual quality of the disclosures has not been assessed explicitly.

The analysis CESR undertook required the application of judgement and consequently materiality considerations need to be taken into account in order to put the figures presented in this report into perspective. The analysis was performed without any investigation of the underlying accounting and consequently it is important that the results of this analysis are considered entirely independently from any enforcement actions contemplated or which may at some point in the future actually be undertaken by national enforcers.

This CESR statement focuses on five key areas related to disclosures of financial instruments:
1. Categories of financial assets or financial liabilities and their carrying amounts
2. Financial assets and liabilities at fair value
3. Risks arising from financial instruments
4. Special Purpose Entities (SPEs)
5. Impairment of financial instruments

Categories of financial assets or financial liabilities and their carrying amounts
CESR found a good level of compliance with disclosure requirements on the classification of financial assets and liabilities and their carrying amounts under IFRS 7. Many entities enhanced their fair value disclosures on certain instruments they believed to be of importance for users and provided additional information to help users to better understand the financial statements.

Financial assets and liabilities at fair value
IFRS 7 requires extensive disclosures regarding financial assets and liabilities held at fair value, as fair value movements can have a substantial impact on a company's financial position and performance. CESR considered valuation techniques, sensitivity analysis, the recognition of day one profit or losses, own credit risk, the fair value hierarchy and unobservable inputs.

If the market for a financial instrument is not active, an entity is required to establish fair value by using a valuation technique, which should be explained. Although most entities disclosed the methods they had applied when using a valuation technique to determine fair values for classes of financial assets and/or liabilities, around 20% of all companies and almost 10% of FTSE Eurotop-companies did not make such disclosures. Around 40% of all companies (10% of FTSE Eurotop-companies) did not disclose the sensitivity of fair values recognised in the financial statements to changes in the various assumptions.

In addition, around half of all companies, and about 15% of FTSE Eurotop-companies, did not provide either the aggregate difference in fair value estimates yet to be recognised, or a reconciliation between the opening and closing balances. This information can be important for users as there can be a difference between the fair value at initial recognition and the amount that would have been determined at that date using a valuation technique.

Around one third of all companies (half of the FTSE Eurotop-companies) followed recommended practices and disclosed whether valuation techniques were based on significant unobservable inputs and if relevant, a description of the sources of those unobservable inputs into the valuation techniques. Furthermore, although disclosures based on the fair value hierarchy were non-mandatory at the time, more than half of the financial entities CESR examined applied the hierarchy in their financial statements. CESR believes that disclosure of fair value hierarchies and related information is decision-useful information for users.

Extensive additional guidance and disclosure recommendations have been published regarding the importance of valuation techniques. More than half of the companies followed CESR's recommendation to disclose a summary of their valuation procedures.

Risks arising from financial instruments
Proper disclosure of risk is crucial for investors and other users of financial statements, particularly during more difficult market conditions. CESR's analysis showed that for the three types of risk analysed (credit risk, liquidity risk and market risk) the general qualitative and quantitative disclosure requirements of IFRS 7 had been provided by almost all companies. However, some of the more detailed disclosure requirements for credit risk were not provided to the same extent. About 35% of entities did not disclose a description of the collateral held by the entity as security or any other credit enhancements.

Disclosure analysing liabilities by contractual maturity can help users of financial statements to assess the nature and extent of liquidity risk. Such disclosures were provided by almost all companies. In addition, CESR noted that overall a relatively high proportion of companies had chosen to early adopt the amendments to IFRS 7 (which were still at the proposal stage in 2008) relating to liquidity risk in their financial statements.

Special Purpose Entities

The analysis showed that around 40% of the companies analysed did not have any special purpose entities (SPEs). Of the remainder, around 20% of all companies did not disclose details of how they had exercised their judgement on whether the substance of the relationship between the entity and a SPE indicated that the SPE is controlled by that entity. A smaller proportion of FTSE Eurotop companies did not provide these disclosures compared to the sample as a whole. The greater use of and extent of the role, size and transactions with SPEs of these companies might be the primary reason for this increased compliance.

In addition, around 20% of the companies having SPEs did not disclose details of how they had exercised their judgement in deciding when all the significant risks and rewards of ownership of financial assets had been transferred to other entities. CESR expected that the number of companies not providing sufficient disclosures regarding their activities with off balance sheet entities would have been much lower, given this information is highly relevant for an understanding of the financial statements.

Impairment of financial instruments

CESR also believes it is important for users to understand the criteria an entity uses to determine whether there is objective evidence that an impairment loss for an available for sale equity instrument has occurred. CESR noted that around 80% of all companies analysed (90% of the FTSE Eurotop-companies) had impairment losses for financial instruments in 2008. A small number of companies (5%) did not disclose a summary of accounting policies including the criteria they use to determine that there is objective evidence that an impairment loss has occurred relating to equity instruments classified as available for sale.

Audit

The CESR analysis considered the audit opinion contained in the financial statements. 2% of the companies sampled had a modification relating to a non compliance with IFRS while around 10% contained an emphasis of matter paragraph; around half of these emphasis of matter paragraphs related to going concern issues in the context of the financial crisis, and the remainder related to various other specific issues. CESR performed no work to how the auditors concerned may have reached their opinion.

Future Steps

CESR will continue in its role of co-ordinating European enforcement decisions and will organise discussions relating to any enforcement actions resulting from the issues contained in this report. As securities regulators, CESR members will continue to monitor closely future developments in the area of accounting, especially for financial instruments.

CESR will also consider which areas in IFRS and its application would be of particular interest in the light of market conditions and any other future developments regarding accounting standards.

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1. Introduction

The financial crisis has had a major impact on the financial position and performance of publicly traded companies, particularly those in the financial sector. Strengthening investor confidence requires improved transparency on the actual situation of financial companies. A key role for CESR is to monitor the application of accounting requirements under International Financial Reporting Standards (IFRSs). In the current context of market turbulence a particular area of interest is the information provided on the treatment of financial assets and liabilities.

During the financial crisis (when some markets became illiquid) the objective of ensuring proper and sufficient market transparency for investors and other users of financial statements became even more important because of the complexity of the accounting requirements for financial instruments and the uncertainties that surround their valuation. This remains true independently of whether or not the valuation of the financial instruments is based on unobservable market data.

In producing this statement, CESR aims to contribute to enhancing market confidence by reiterating the importance of appropriate application of IFRSs and related recommendations.

It is important that, to enhance the ability of investors to compare the relative financial position and performance of issuers, a proper presentation of performance and changes in financial position along with relevant disclosures about risk exposures, is provided. Several IFRSs call for management judgment and the use of assumptions and valuation methods. Clear and understandable disclosure of these factors in respect of an entity's financial instruments (including the uncertainties inherent in underlying assumptions and in valuation methods) is important for an understanding of an entity's financial position, performance and risk profile.

The analysis

CESR's analysis deals with the application of the mandatory disclosure requirements of IFRS 7 – *Financial Instruments: Disclosures* and with additional recommendations and guidance on disclosure in the following areas:

a. Categories of financial assets and financial liabilities
b. Financial assets or financial liabilities at fair value and their carrying amounts
c. Risks arising from financial instruments
d. Special Purpose Entities (SPEs)
e. Impairment for financial instruments

Since the onset of the financial crisis, a number of parties have issued recommendations and guidance for issuers to consider when applying the requirements of IFRS 7. In addition to the mandatory disclosures required by IFRS 7, CESR has analysed the implementation of the following recommendations and guidance[1]:

- The Financial Stability Forum Statement on Enhancing Market and Institutional Resilience, 7 April 2008[2].
- The Senior Supervisors Group Leading-Practice Disclosures for Selected Exposures, 11 April 2008[3].
- The CESR statement on Fair Value Measurement and related disclosures for financial instruments in illiquid markets, 3 October 2008[4].
- The IASB ED[5] *Improving Disclosures about Financial Instruments,* 15 October 2008[6].

[1] It should be noted that the recommendations and guidance concerned were not mandatory for the 2008 financial statements. Some of this guidance may since have been incorporated into IFRS and if endorsed in Europe, would be applicable for future reporting periods.

[2] http://www.fsforum.org/publications/r_0804.pdf

[3] http://www.fsa.gov.uk/pubs/other/ssg_exposures.pdf

[4] http://www.cesr.eu/popup2.php?id=5285

[5] Exposure Draft (ED)

- The Report from the IASB Expert Advisory Panel, 31 October 2008[7].
- The IASB ED 10 *Consolidated Financial Statements*, 18 December 2008[8]

In carrying out the analysis, judgment has been applied in assessing whether the issuer has complied with the requirements or recommendations and guidance set out above. Some of that material is, or is in the process of becoming, integrated into IFRS disclosure requirements. Consequently, although some of the material concerned was only providing additional guidance on those requirements that already existed for 2008 year-ends, it should be noted that such material was not actually mandatory at the point the accounts reviewed by CESR were produced. The IASB is now proposing to delete some of the disclosure requirements that were mandatory for 2008 financial statements.

CESR's analysis makes a distinction between the extent to which mandatory requirements were fulfilled opposed to related complementary guidance. The analysis has focused on compliance with the disclosure requirements or recommendations selected; the actual quality of the disclosures has not been explicitly assessed. The financial statements have been reviewed solely for the purpose of this analysis, and the results of the analysis must be consequently considered separately from any enforcement actions which may be taken by national enforcers.

The sample consisted of 96 companies which were selected to provide an appropriate reflection of the distribution of financial companies (banks and/or insurers) within the European market. 22 of the entities in the sample are included in the FTSE Eurotop 100[9] index. In this document, analysis of the FTSE Eurotop companies is (usually) presented in addition to the analysis of the sample as a whole as CESR believes that FTSE Eurotop-companies, being the largest financial companies in Europe, have their financial statements subjected to the highest level of market scrutiny.

In this analysis the sample of FTSE Eurotop companies is the same as in the two previous analyses carried out by CESR namely the CESR statement on *"Reclassification of financial instruments and other related issues[10]"*, published in January 2009 and on *"Application of and disclosures related to the reclassification of financial instruments[11]"* published in July 2009. The composition of other companies in the sample has been slightly amended compared to the previous analysis, in order to better reflect the distribution of financial companies within the European market.

The analysis is based on a questionnaire for each entity in the sample completed by national enforcers. The questions were structured such that responses could be "yes", "no" or "not applicable". Percentages compiled and bar charts presented are based purely on returns related to companies to whom the relevant disclosure was thought to apply i.e. answers of "not applicable" were excluded when compiling the percentages. All references to IFRS standards are made to the standards that were applicable for the 2008 financial statements. Subsequent amendments to IFRSs may consequently have changed some of the paragraph numbers referred to in this statement.

It is important to bear in mind that the sample includes banks and insurance companies. Different business models mean that some disclosure areas may be of lesser or greater relevance for individual entities.

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[6] http://www.iasb.org/News/IASB+enhances+financial+instruments+disclosures.htm. The exposure draft was issued as a final standard in March 2009. The final standard still awaits endorsement by the European Parliament before it is applicable to be used in Europe.
[7] http://www.iasb.org/News/Press+Releases/IASB+publishes+educational+guidance+on+the+application+of+fair+value+measurement+when+markets+become.htm
[8] http://www.iasb.org/Current+Projects/IASB+Projects/Consolidation/Exposure+Draft+and+Comment+Letters/Exposure+Draft+and+Comment+Letters.htm
[9] Hereafter called FTSE Eurotop companies.
[10] http://www.cesr-eu.org/popup2.php?id=5445
[11] http://www.cesr-eu.org/popup2.php?id=5802

It should also be noted that the analysis presented involved judgement and that materiality therefore may need to be taken into account to put some of the figures into perspective. The reason for non-compliance with some disclosure requirements may be that the disclosures were simply considered non material and therefore omitted from the financial statements.

In addition, the analysis has focused on compliance or non-compliance with selected disclosure requirements. The actual quality of the compliance with the requirements or recommendations has not been explicitly assessed as part of this analysis.

2. Categories of financial assets and liabilities and their carrying amounts

CESR believes disclosures regarding the categories of financial instruments that an entity holds assist users of financial statements in understanding the extent to which accounting policies and economic events affect the amounts at which financial assets and liabilities are recognised. Together with disclosures of the gains and losses by category of financial instrument, the disclosure of the carrying amounts for each category of financial instruments allows users to evaluate the effectiveness of management's decisions regarding the financial assets and liabilities a company holds.

According to IFRS 7 paragraph 8 an entity is required to disclose the carrying amount of each category of financial assets and liabilities as defined in IAS 39[12]. All companies in the sample complied with this requirement[13].

Whenever IFRS 7 requires disclosures by class of financial instrument, IFRS 7 paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position. About 85% of the entities sampled grouped financial instruments into classes at a more detailed level than the categories defined in IAS 39.

In addition to these mandatory IFRS 7 requirements, CESR considered the disclosure recommendations as suggested by the IASB Expert Advisory Panel which elaborate on the principles in IFRS 7. Such analysis showed that the majority of companies made these additional disclosures. Specifically:

- Around 90% of all companies and 100% of FTSE Eurotop-companies provided information at an appropriate level of aggregation and granularity, including sufficient information by product class, to help users understand the information more easily. The companies sampled also reported in a way which enabled users to locate the information more easily, for example, by providing a clear linkage between the quantitative and qualitative disclosures (IASB EAP report paragraphs 123-127).
- 70% of all companies and all but one FTSE Eurotop-company disclosed more detailed or enhanced fair value disclosures about instruments they believed to be of particular interest

[12] IAS 39 defines the following categories in paragraph 9:

a) financial assets at fair value through profit or loss, showing separately those designated as such upon initial recognition and those classified as held for trading in accordance with IAS 39;
b) held-to-maturity investments;
c) loans and receivables;
d) available-for-sale financial assets;
e) financial liabilities at fair value through profit or loss, showing separately those designated as such upon initial recognition and those classified as held for trading in accordance with IAS 39; and
f) financial liabilities measured at amortised cost.

[13] It should be noted that the IASB has published an ED *Financial Instruments: Classification and Measurement* in July 2009 which suggests a new model for categorisation of financial instruments.

to users, including descriptions and numerical disclosures such as disclosures by exposure type, net and gross disclosures, disclosures by tranche and by vintage (IASB EAP report paragraphs 114-117).

3. Financial assets or financial liabilities at fair value

Information regarding fair value allows comparisons to be made between financial instruments having substantially the same economic characteristics, regardless of why such instruments are held, and when and by whom such instruments were issued or acquired. IFRS 7 requires extensive disclosures when an entity has designated loans and receivables as at fair value through profit or loss. This is mainly because applying the fair value option to these instruments may have a significant impact on a company's financial statements merely as a result of changes in credit risk. The downward trend in fair value movements resulting from the deterioration in the markets led CESR to consider the disclosure requirements related to fair value accounting for financial instruments, as CESR believes such disclosures to be indispensable for a good understanding of an entity's current and expected financial position.

CESR analysed the existing mandatory disclosure requirements in IFRS 7 (as applicable to 2008 accounts) as well as those disclosures suggested by recommendations and guidance. CESR believes disclosures related to the fair value hierarchy and unobservable inputs, sensitivity analysis, the recognition of day one profit or losses and own credit risk are important areas to be assessed in relation to the financial crisis. This section consequently focuses on the results of the CESR analysis in these areas.

3.1 Fair value hierarchy and unobservable inputs

3.1.1 Fair value hierarchy

Proposals for further convergence between US GAAP and IFRS with regards to disclosures relating to the fair value hierarchy, partly as a response to measurement difficulties in inactive markets, made such disclosures a topic of intense debate in the latter part of 2008. None of the proposed disclosures relating to the fair value hierarchy were thus mandatory for 2008 financial statements. CESR contributed to the debate by issuing its statement "*Fair value measurement and related disclosures of financial instruments in illiquid markets*" which was published in October 2008. That same month, the IASB Expert Advisory Panel published its report which provided enhanced guidance on valuing, or disclosing information relating to financial instruments when markets are no longer active.

Amendments to IFRS 7 were proposed by the ED *Improving Disclosures about Financial Instruments* which was published by the IASB in October 2008[14] and CESR examined whether companies were already applying any of the ED's requirements relating to the fair value hierarchy in their 2008 financial statements. As these will be mandatory for 2009 financial statements, CESR decided to analyse the extent to which the entities sampled made the relevant disclosures earlier.

The ED required entities to classify fair value measurements using a fair value hierarchy that reflects the reliability of the inputs used for measurement. The fair value hierarchy proposed consists of three levels:

(i) **Level 1** – Quoted prices (unadjusted) in active markets for identical assets or liabilities;

[14] A final standard with these amendments was issued in March 2009, effective for accounting periods beginning on or after 1 January 2009. The amendments are not yet endorsed for use in the European Union and will be mandatory for the financial statements for 2009, at the earliest.

(ii) **Level 2** – Inputs, other than quoted prices included within Level 1, that are observable for the asset or liability, either directly or indirectly; and

(iii) **Level 3** – Inputs for the asset or liability not based on observable market data.

When analysing the application of the fair value hierarchy CESR has not focused its analysis on level 1 inputs but has analysed those disclosures made on the basis of the requirements of levels 2 and 3.

The analysis shows that around 50% of all companies (around 60% of FTSE Eurotop-companies) applied the fair value hierarchy. Of these, the proportion of companies applying the various requirements of the fair value hierarchy set out in the exposure draft is shown in the graph below.

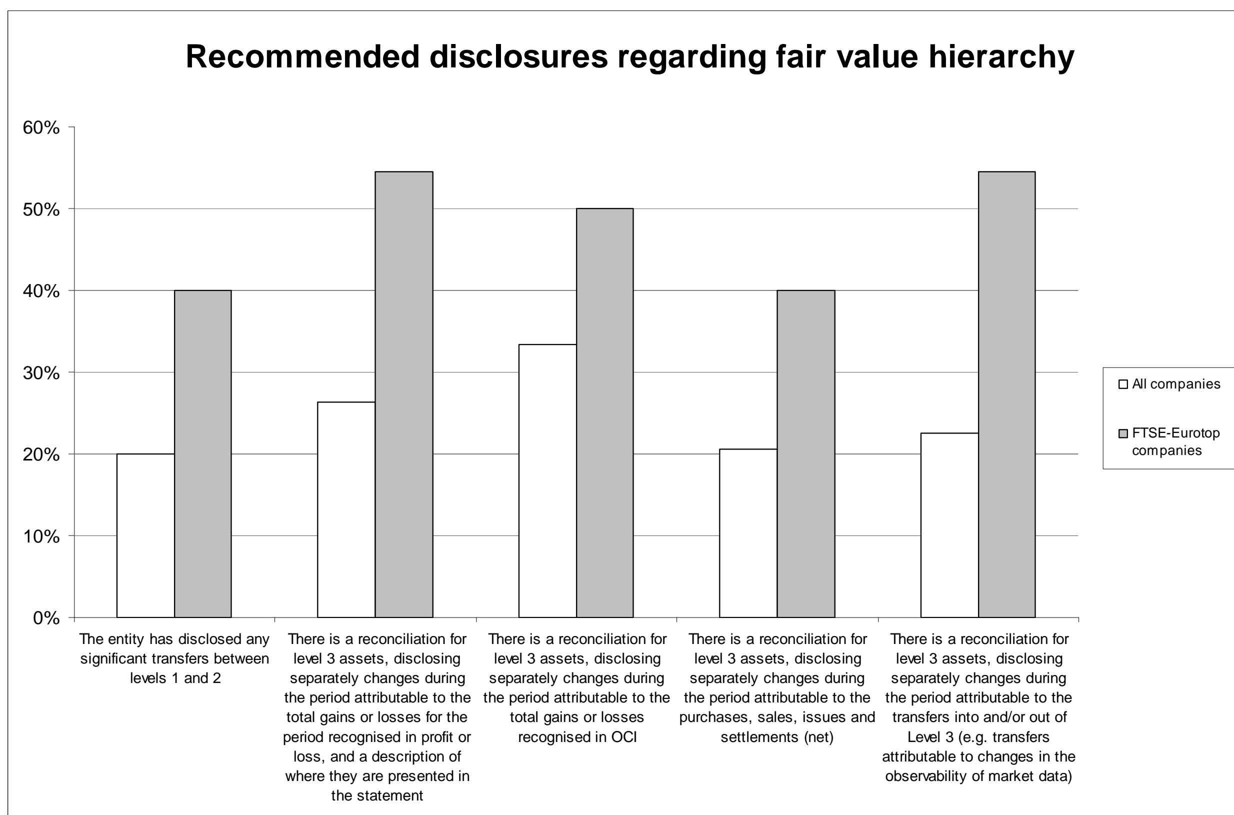

Figure 1: Recommended disclosures provided regarding the fair value hierarchy as a proportion of companies that applied the fair value hierarchy

The analysis showed that around 50% of all companies sampled (around 60% of FTSE Eurotop companies) early adopted the future disclosure requirements regarding the fair value hierarchy contained in the ED. FTSE Eurotop companies applied the amendments to a greater extent than the other companies, which is in line with CESR's expectations.

A number of FTSE Eurotop-companies also provided the other disclosures that were suggested in the exposure draft in their financial statements for 2008.

CESR supported the introduction of the fair value hierarchy. In its statement on *Fair value measurement and related of financial instruments in illiquid markets* from October 2008 CESR also expressed the view that a tabular format helps making the information accessible and comprehensible to investors. CESR welcomes the early application of these requirements by some European financial companies. CESR believes that presentation in accordance with this hierarchy helps 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. Therefore CESR welcomes the fact that more than half of the entities sampled applied the fair value hierarchy

voluntarily in their 2008 financial statements and notes that this information is highly important and relevant for investors.

3.1.2 Valuation techniques

One of the main issues related to inactive markets in general is the application of valuation techniques. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length transaction motivated by normal business considerations (IAS 39 paragraph AG75). However, fair values estimated by valuation techniques are more subjective than those established from an observable market price, and users therefore need more information to assess the extent of that subjectivity. It is therefore important that an entity discloses the methods and, when a valuation technique is used, the assumptions applied in determining the fair value of each class of financial asset or financial liability (IFRS 7 paragraph 27a).

Mandatory disclosures
Due to the financial crisis more markets became inactive, which resulted in a much wider use of valuation methods, and a greater interest in the related disclosure requirements. This section sets out the results of CESR's analysis of disclosures regarding valuation techniques.

Although most entities disclosed the methods used when they applied a valuation technique in determining fair values for particular classes of financial assets and/or liabilities (for example whether the valuation technique is commonly used by market participants[15]), around 20% of all companies sampled and almost 10% of the FTSE Eurotop companies did not make such disclosures. Apart from being mandatory, CESR considers such disclosures highly important as was also highlighted in the IASB Expert Advisory Group report (paragraphs 118-122).

CESR's analysis also showed that 15% of all companies (around 10% of FTSE Eurotop companies) did not state whether fair values recognised or disclosed in the financial statements were determined in whole or in part using a valuation technique based on assumptions that were not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and were consequently not based on available observable market data (IFRS 7 paragraph 27c).

When the requirement mentioned above applies to a company, it also has to disclose the total amount of the change in fair value estimated using such a valuation technique that was recognised in profit or loss during the period (IFRS 7 paragraph 27d). 45% of the companies sampled (about 20% of FTSE Eurotop companies) did not provide disclosures complying with this requirement (see figure 2 below).

[15] IAS 39 paragraph AG74

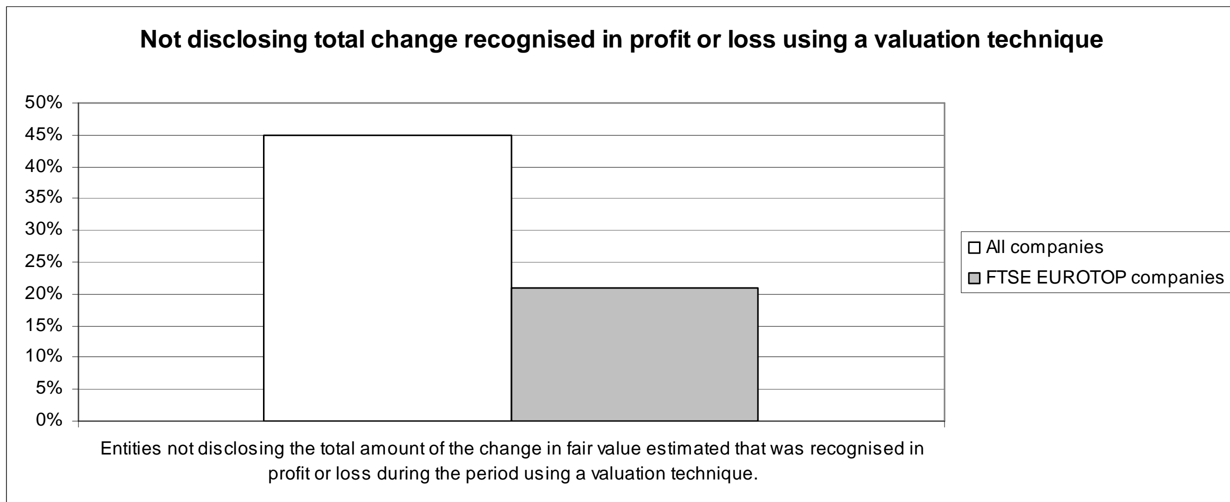

Figure 2: Number of entities not disclosing the total amount of the change recognised in profit or loss using a valuation technique

An entity has to disclose whether fair values are determined using a valuation technique based on assumptions that are not supported by prices from observable current market transactions. In addition the entity is required to disclose, whether changing one or more of those assumptions to reasonably possible alternative assumptions would change significantly the fair value derived and the effect of making those changes (IFRS 7 paragraph 27). The results of CESR's analysis of companies' application of this requirement are shown in figure 3 below.

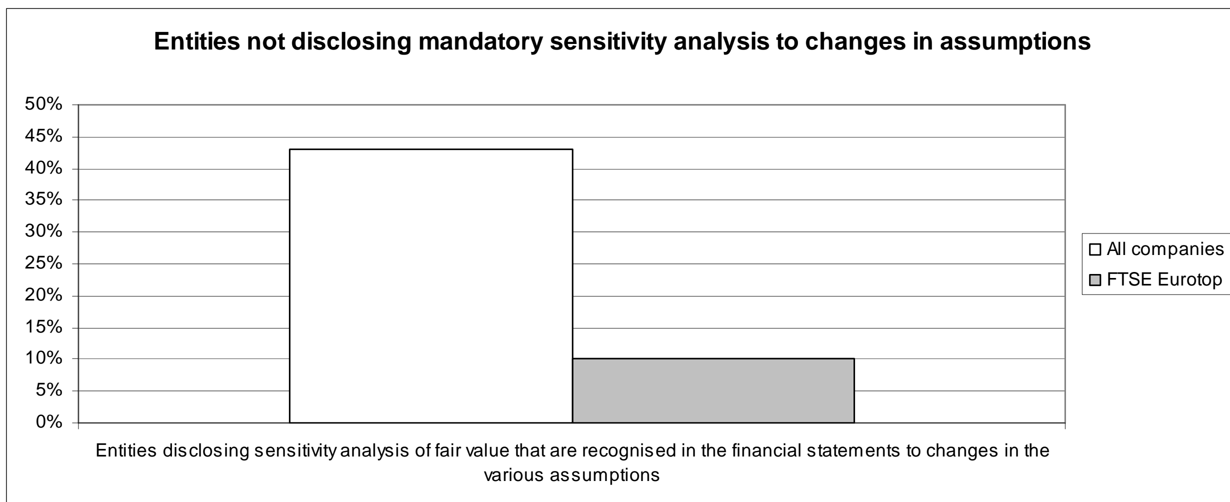

Figure 3: Entities' mandatory sensitivity analysis of fair values that are recognised in the financial statements to changes in the various assumptions.

Two thirds of all entities analysed were in a position where they were obliged to disclose the sensitivity of fair values recognised in their financial statements to changes in the various assumptions underlying those fair values (with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, with respect to total equity). Around 40% of the companies (10% of FTSE Eurotop-companies) did not comply with this requirement.

As the use of valuation techniques may often entail a significant amount of judgement, and may thus be subject to significant sensitivity, management should be in a position to explain the criteria, assumptions and inputs relevant to the valuation techniques chosen in order to ensure consistency.

CESR would have expected a higher level of compliance with these mandatory requirements, which CESR believes are important in enabling users to assess an entity's performance.

Additional guidance on disclosures.

The IASB Expert Advisory Panel report states that a discussion of the valuation technique applied by an entity is important in meeting the objective of helping users of financial statements to understand the techniques used and the judgements made in measuring fair values. Items to be considered when disclosing information about valuation techniques would include for example:

(i) whether there is a choice of valuation technique and how that choice is made;
(ii) a description of the risks or shortcomings (if any) of the selected valuation technique,
(iii) if there has been a change to the valuation technique from previous reporting periods and the reason for making the change;
(iv) the frequency and methods used to calibrate the model to market prices;
(v) a description of the use of broker quotes or pricing services;
(vi) when adjustments are made to model values for factors that the model does not incorporate, what these factors are and how adjustments are made;
(vii) a description of the facts and circumstances that led to the determination that a market is active or inactive; and
(viii) the criteria used to decide whether a transaction was forced, and therefore not used in the fair value measurement.[16]

CESR has analysed the application of these recommendations and the results are shown in figure 4 below.

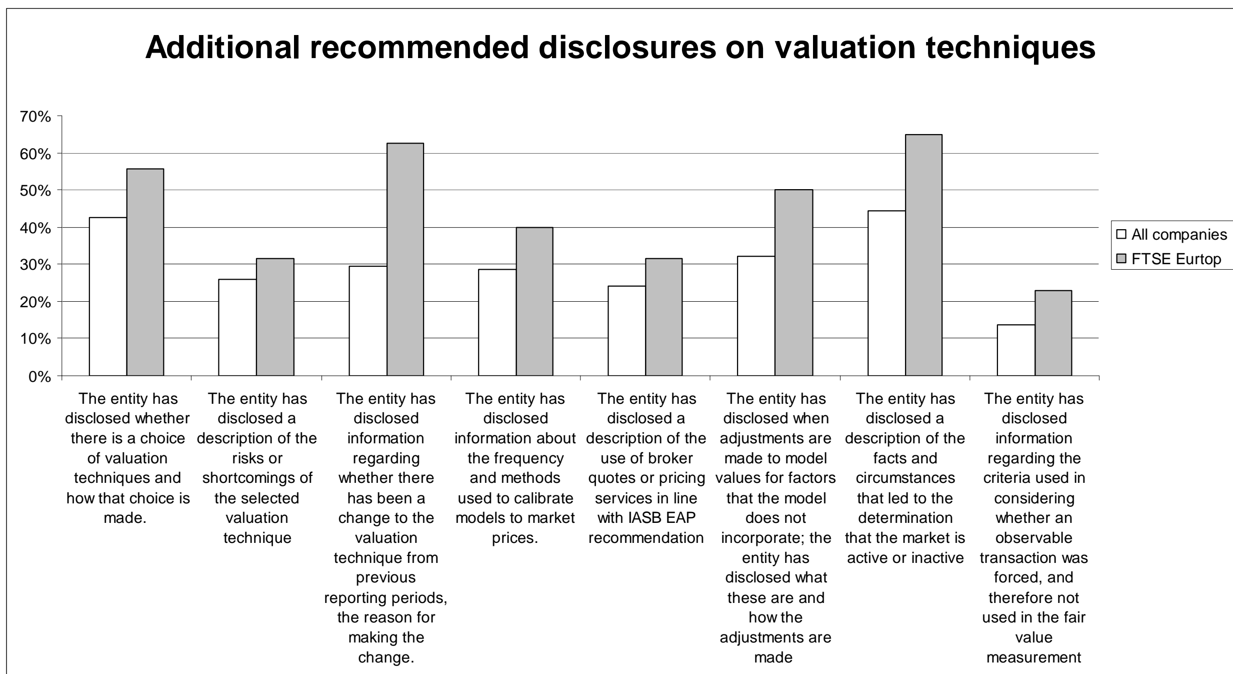

Figure 4: Additional recommended disclosures on valuation techniques

As figure 4 illustrates, a greater proportion of FTSE Eurotop companies adopted these recommendations when compared to the other companies analysed. CESR welcomes the fact that companies voluntarily provide this information as CESR believes that information about the use of

[16] IASB Expert Advisory Panel, Measuring and disclosing the fair value of financial instruments in markets that are not longer active, paragraph 135.

valuation techniques and the assumptions underlying them is key information which contributes to better quality, more transparent financial statements resulting in more decision-useful information for users. CESR stressed the importance of disclosure requirements and the proper use of valuation techniques in its October 2008 statement[17];

> *"When there is no active market for financial instruments, [the] companies are required to apply valuation techniques and to use assumptions, which entails an increased use of management's judgement. Under the current market conditions it could be difficult for companies to identify the relevant market inputs for the valuation models. There is therefore a risk that reduced market activity and increased difficulties to determine fair value using quoted prices could generate inconsistent application of the requirements regarding measurement at fair value among issuers. Moreover, the complexity of valuation and the uncertainty that surrounds it make it all the more important to ensure that investors receive sufficient information on how instruments are valued."*

CESR's analysis showed that 55% of all companies and almost 45% of the FTSE Eurotop-companies in the sample disclosed a summary of valuation procedures in accordance with the CESR statement. CESR once again highlights that this information is highly important and relevant for investors and more issuers should consider providing this information in their financial statements.

3.1.3 Unobservable inputs

IFRS 7 as applicable for 2008 year-ends did not contain defined, detailed requirements regarding disclosures on unobservable inputs for financial instruments. The CESR statement on *Fair Value Measurement and Related Disclosures for Financial Instruments in Illiquid Markets* from October 2008 and the IASB Expert Advisory Panel report both discuss the use of unobservable market input.

When a fair value measurement uses a valuation technique based significantly on inputs that are unobservable (i.e. those inputs that are used in a valuation technique at level 3 and that are not supported by a current, observable market transaction), an entity is required to disclose the movement in fair value recognised in profit or loss during the period (IFRS 7.27 (d)). An important element in understanding any fair value measurement is an ability to understand the assumptions made and inputs applied in the valuation technique used to arrive at that fair value.

A description of the source of the inputs gives users a better understanding of the valuation. For assumptions and inputs that are unobservable or difficult to estimate, informative and transparent disclosures allow users to develop a more informed view as to the reasonableness of the valuation methodologies and the assumptions applied. CESR examined whether entities:

(i) Disclosed the extent to which significant unobservable inputs are used in valuation techniques;
(ii) Provided information by class of instruments, by risk type or both rather than as a single disclosure that encompasses all financial instruments; and
(iii) Disclosed a description of the sources of the unobservable inputs.

The results of the analysis are shown in figure 5 below.

[17] CESR Statement on Fair Value Measurement and Related Disclosures of Financial Instruments in Illiquid Markets, October 2008.

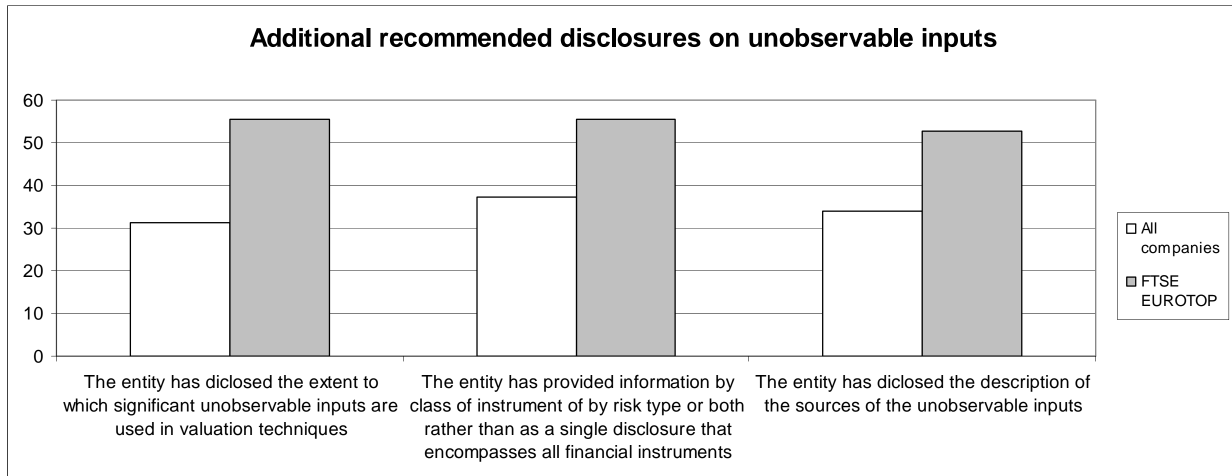

Figure 5: Additional recommended on disclosures unobservable inputs

Around one third of all companies (half of the FTSE Eurotop-companies) disclosed whether sources of unobservable input are used in valuation techniques and whether such companies also provided the information by class of instruments instead of on an aggregated level and a description of the sources of the unobservable inputs[18].

In preparing their 2009 financial statements, CESR encourages issuers to consider the disclosures related to unobservable inputs recommended in the IASB ED on Fair Value Measurements[19] and the IASB Expert Advisory Panel report.

3.2 Sensitivity analysis

Mandatory disclosures

Information about the use of valuation techniques should be disclosed to provide users of financial statements with a sense of the potential variability of fair value movements, in particular the sensitivities of fair value estimates to the main valuation assumptions should be disclosed. For fair values that are recognised through profit or loss, if changing one or more of those assumptions to reasonably possibly alternative assumptions would change fair value significantly, then the entity should disclose the effect of those changes (IFRS 7 paragraph 27c). Disclosures about the effect of reasonably possible alternative assumptions is likely to provide useful and transparent information if the sensitivity analysis is provided at a disaggregated level.

The results of CESR's analysis whether companies provided information about mandatory sensitivity analysis is presented under section 3.2.1 Valuation Techniques.

In addition, according to IAS 1 paragraph 113 an entity shall disclose, in the summary of significant accounting policies or other notes, the judgements (apart from those involving estimations) that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. The analysis showed that 25% of all companies (around 10% of FTSE Eurotop companies) did not identify or disclose any judgement, apart from those involving estimations, relating to the measurement of financial instruments at fair value.

[18] CESR also highlighted this issue in its October 2008 statement and appreciates that a significant number of companies quoted in the FTSE Eurotop Eurotop 100 have disclosed this information.
[19] The final standard based on the IASB ED on fair value measurement is expected to be issued in the second quarter of 2010. Thereafter the final standard will be subject to the endorsement process in Europe before becoming mandatory for European issuers.

IAS 1 paragraph 116 requires an entity to disclose information about its key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, which have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

(a) their nature; and
(b) their carrying amount as at the balance sheet date.

The analysis showed that around 20% of all companies (around 10% of FTSE Eurotop companies) did not disclose key sources of estimation uncertainty that may lead to material adjustment to the carrying amount of financial instruments measured at fair value which are not based on recently observed market prices in accordance with IAS 1 paragraph 116. CESR would have expected a higher level of compliance with these mandatory requirements, particularly in light of market conditions.

Additional guidance on disclosures

Disclosures about the effect of reasonably possible alternative assumptions can be enhanced through disclosure of how the effect has been calculated; this allows users to better understand disclosures and what the figures presented in them represent. The IASB Expert Advisory Panel suggests an entity to consider explaining:

(i) What the entity regards as a reasonably possible alternative assumption.
(ii) Why the assumption used in the fair value measurement was selected rather than reasonably possible alternative(s).
(iii) How the entity calculated the effect disclosed.
(iv) Whether the disclosure takes into account any offsetting or hedged positions.
(v) Whether the effect disclosed represents the movement in a single input or a movement in all unobservable inputs.

CESR considered the level of compliance with these recommendations. The findings are presented in figure 6 below.

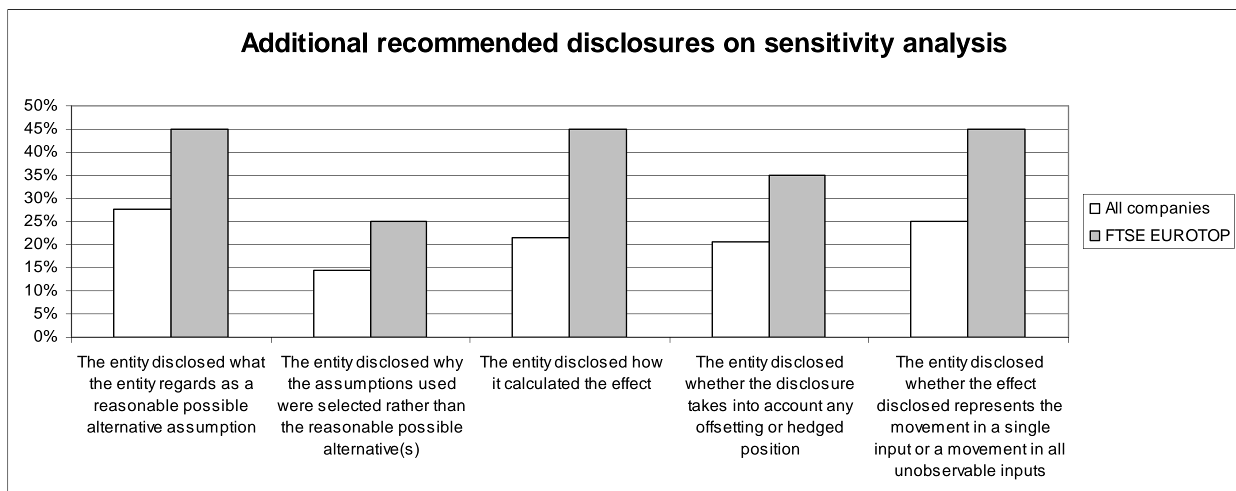

Figure 6: Disclosures on sensitivity analysis

The analysis shows that a greater proportion of FTSE Eurotop-companies voluntarily provided the disclosures recommended by the IASB Expert Advisory Panel regarding sensitivity analysis of high risk exposures as compared to the sample as a whole. CESR therefore particularly welcomes the initiative by the FTSE Eurotop-companies to provide users with further information as we think

sensitivity analysis is important for users to fully understand fair value movements in an entity's performance.

3.3 Day 1 profit or loss

If the market for a financial instrument is not active, an entity shall establish its fair value using a valuation technique[20]. Nevertheless, according to IFRS 7 paragraph 28 and IAS 39 paragraph AG 76 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. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using a valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument[21]:

(i) Its accounting policy for recognising that difference in profit or loss to reflect a change in factors that market participants would consider in setting a price; and
(ii) The aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

Whilst 60% of the companies analysed would actually have had to disclose an aggregate difference yet to be recognised, and to provide a reconciliation between opening and closing balances, around half of those companies, and about 15% of the equivalent population of FTSE Eurotop-companies, did not do so (see figure 7 below). CESR would have expected that a higher number of entities would have provided this mandatory disclosure.

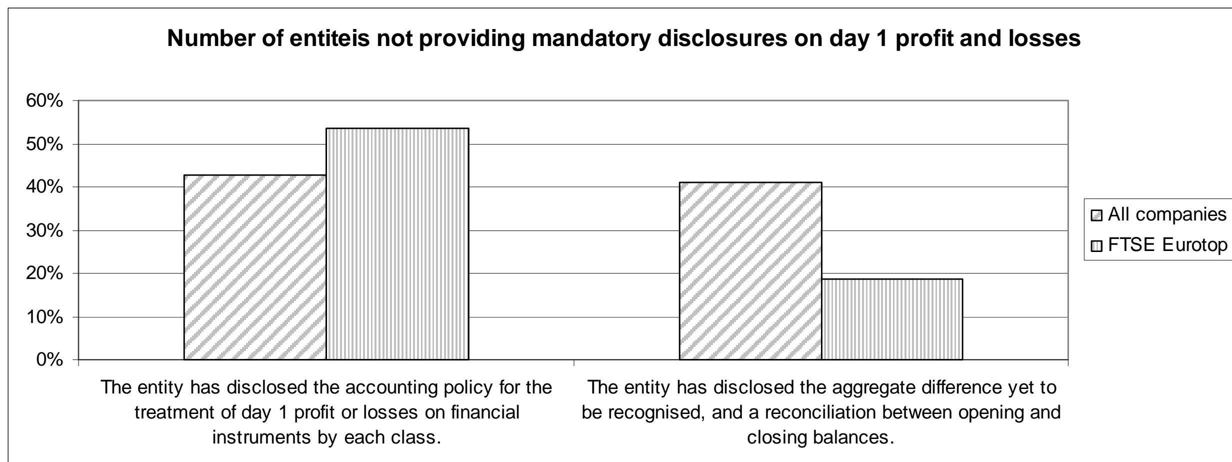

Figure 7: Number of entities not providing mandatory disclosures on day one profit or losses

3.4 Own credit risk

Own credit risk is not specifically defined in IFRS 7. For financial liabilities designated as at fair value through profit or loss, an entity is required to disclose the amount of any change in a liability's fair value that is attributable to changes in the entity's own credit risk. In essence this means that if an entity's credit standing deteriorates, the fair value of its liabilities is lower, resulting in a fair value gain being recognised. Similarly, if an entity's credit standing improves, the fair value of its liabilities is higher, resulting in a fair value loss being recognised.

[20] See IAS 39 paragraph AG74-AG79
[21] IFRS 7 paragraph28

Where an entity has designated financial liabilities at fair value through profit or loss, IFRS 7 paragraph 10 requires disclosure about creditworthiness. These disclosures have been included in the standard to help alleviating concerns that users may misinterpret the profit or loss effects attributable to changes in the issuer's own credit risk. To help users to better understand the changes recorded in profit or loss when the entity's credit rating changes, disclosures of the changes in fair value attributable to changes in that credit risk should be provided.

The analysis showed that both 75% of all companies and of FTSE Eurotop-companies sampled designated a financial liability at fair value through profit or loss in accordance with IAS 39.

The disclosure requirements as set out in IFRS 7 paragraph 10-11 and 7 paragraphs B4-B5 only apply to companies that have designated financial liabilities at fair value through profit or loss. The figure below shows the proportion of companies that was required to apply the disclosure requirements but that did not do so.

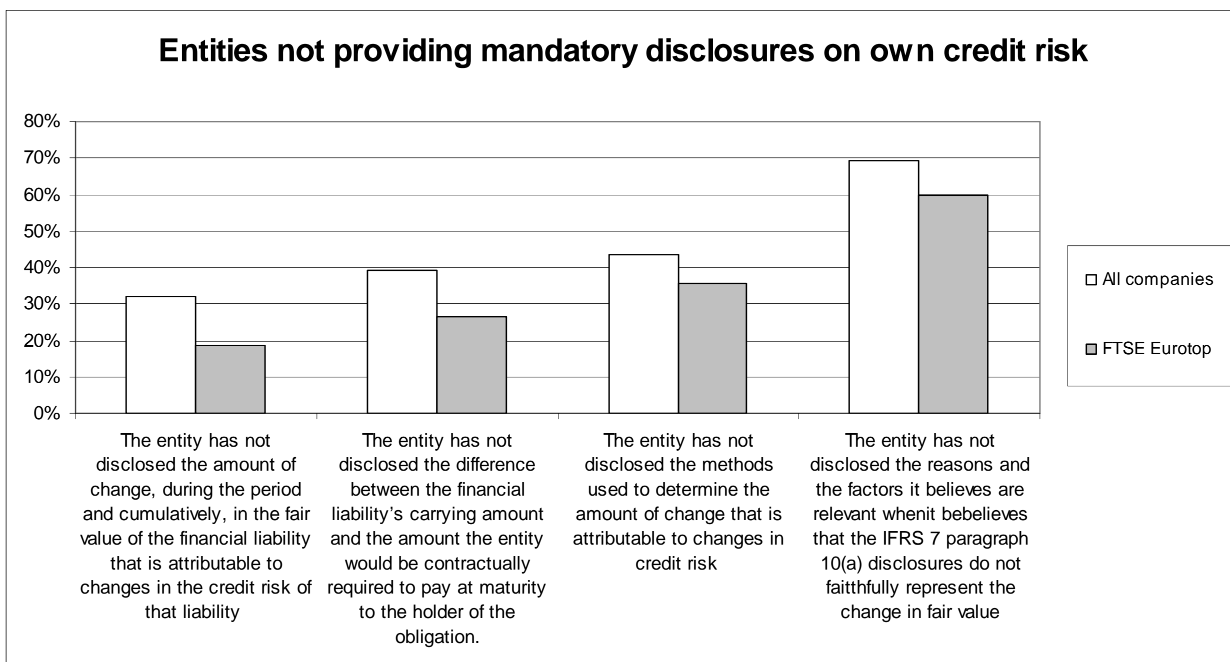

Figure 8: Entities not providing mandatory disclosures on own credit risk

The analysis shows that of those companies that had designated a financial liability at fair value through profit or loss:

- About 60% of the companies sampled were required to disclose the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability in accordance with IFRS 7 paragraph 10a. Of those companies around 30% did not provide such disclosure. Amongst FTSE-Eurotop companies this figure was 18%.
- About 60% of the companies sampled were required to disclose the difference between the financial liability's carrying amount and the amount the entity would contractually be required to pay at maturity to the holder of the obligation in accordance with IFRS 7 paragraph 10b. Of those companies around 35% (almost 25% of FTSE Eurotop companies) did not provide such disclosure.
- About 60% of the companies sampled were required to disclose the methods used to determine the amount of change that is attributable to changes in own credit risk in accordance with IFRS 7 paragraph 11a. Of those companies around 40% (35% of FTSE Eurotop companies) did not provide such disclosure.

- About 30% of the companies sampled were required to provide the reasoning and the factors they believe relevant for coming to the conclusion, having given the disclosures considered in the paragraphs above, that those disclosures do not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk. Of those companies around 70% (60% of FTSE Eurotop companies) did not disclose this information.

Although FTSE Eurotop companies provided the disclosures considered in the previous section to a much greater extent when compared to all companies analysed CESR believes that such disclosure requirements are decision-useful to users of all financial statements and would have expected to have found that all issuers selected would have complied with the existing IFRS requirements on this particular issue.

4. Risks arising from financial instruments

Risk has been a highly important area during the financial crisis as financial companies have experienced exposure to risk to an extent not seen for a very long time, if ever, and this exposure has resulted in some companies suffering substantial losses. The disclosures related to risk have therefore been an area of significant focus for CESR in this analysis. Proper disclosure of risk is always crucial for investors and other users of financial statements, and this is particularly true in current market conditions.

The analysis on risk disclosures has focused on the various types of risks to which an entity is exposed and where disclosures are required by IFRS 7: namely, credit risk, liquidity risk and market risk.

IFRS 7 contains quantitative and qualitative disclosures that are applicable for each type of risk and presents separate disclosure requirements for each type of risk.

4.1 Qualitative and quantitative risk disclosures

The objective of IFRS 7 risk disclosures is to provide users of financial statements with information that enables them to evaluate the nature and extent of risks arising from the financial instruments to which an entity is exposed. General qualitative and quantitative disclosures are set out in IFRS 7 paragraphs 33-35 and typically include, but are not limited to, credit risk, liquidity risk and market risk. The Basel Committee disclosure requirements for banks (Pillar 3) are in line with the disclosure requirements in IFRS 7[22].

An entity shall disclose for each type of risk the exposure to the risk, how it arises, and the entity's objectives, policies and processes for managing the risk and the methods used to measure the risk, according to IFRS 7 paragraph 33. Users want to evaluate an entity's ability to generate returns, and to appreciate the risks and uncertainties of those expected returns. This evaluation can only be meaningful if it is carried out in the context of the entity's risk management policies. In addition the entity shall provide a summary of quantitative information about the exposure to each risk at the reporting date, based on information reported internally to key management personnel.

Regarding qualitative risk disclosures, it is of particular interest for users that entities disclose any changes in the qualitative information from the previous period. Such changes may result from changes in the risk exposure or from changes in the way in which the entity manages its exposures (IFRS 7 paragraph IG17).

[22] Although this allows banks to prepare a single set of co-ordinated disclosures about financial risk, it should be noted that Pillar 3 requirements are broader than IFRS 7 as they include also operational risks.

CESR's analysis shows that the disclosures required in IFRS 7 paragraphs 33-35 on the three types of risk analysed (credit risk, liquidity risk and market risk) have been provided by almost all companies. However, some of the more detailed disclosure requirements for credit risk were not provided to the same extent.

4.2 Credit risk

Credit risk is best explained as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge its obligation. Even organisations that have hedged their loans by buying credit insurance of some sort still face the risk that the insurer will be unable to pay, for example due to liquidity issues. Financial companies are counterparties to many transactions and are thus of special interest to CESR as an organisation of securities regulators. IFRS 7 disclosures about credit risk are substantial and are intended to provide the user with sufficient understanding of the net risk position of financial assets at all stages and the extent to which financial assets are likely to become impaired in the future.

The results of CESR's analysis of the application of the mandatory disclosure requirements related to credit risk are shown in figure 9 below. Besides the qualitative and quantitative disclosures for each type of risk arising from financial instruments, IFRS 7 paragraph 36 calls for an entity to disclose by class of financial instruments:

a) The amount that best represents the maximum exposure to credit risk at the end of the reporting period without taking into account any collateral held or other credit enhancements;
b) In respect of the amount disclosed in (i), a description of collateral held as security and other credit enhancements;
c) Information about the credit quality of financial assets that are neither past due nor impaired; and
d) The carrying amount of financial assets that would otherwise be past due or impaired but whose terms have been renegotiated.

In addition, IFRS 7 paragraph 37 requires an entity to disclose by class of financial asset:

a) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired;
b) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired; and
c) For the amounts disclosed in (i) and (ii), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable[23], an estimate of their fair value.

The results of CESR's analysis regarding credit risk are shown in figure 9 below.

[23] This requirement is proposed for deletion by the IASB in its ED *Improvements to IFRSs* published in August 2009.

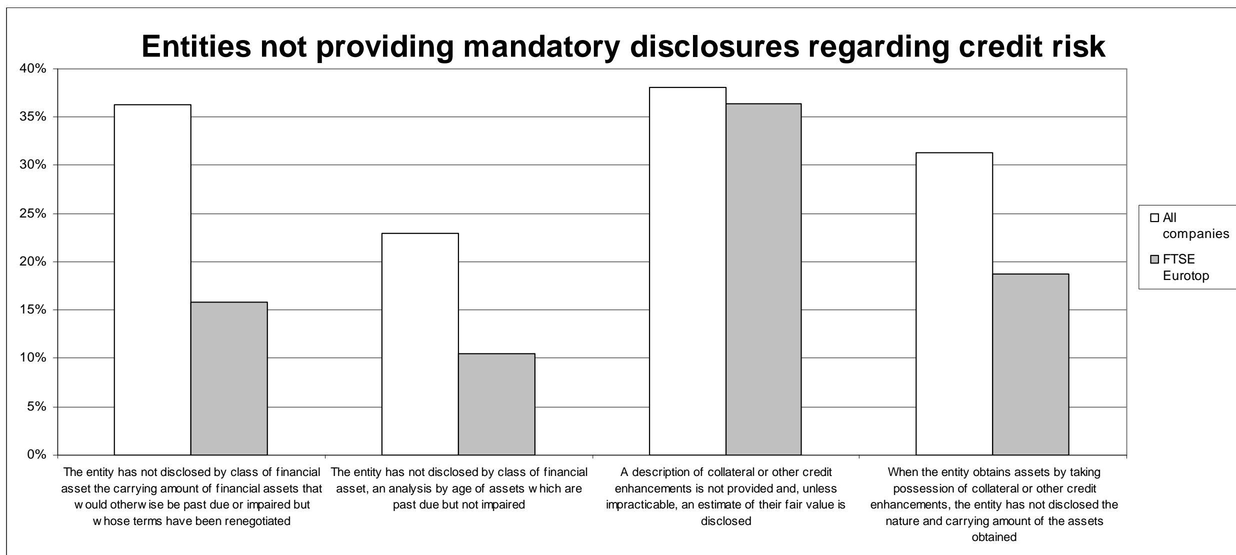

Figure 9: Number of entities not providing mandatory disclosures regarding credit risk

An analysis of the age of financial assets that are past due at the end of the reporting period but are not impaired shall be provided (IFRS 7 paragraph 37a). A financial asset is past due when the counterparty has failed to settle a contractually due payment. Past due status can trigger various actions such as renegotiations, enforcement of covenants, or even legal proceedings (IFRS 7 paragraph IG26). There is however a subtle difference between past due and impaired. Past due occurs when a payment that was contractually due is not settled and may not necessarily mean that a financial asset is impaired. Appropriate disclosures can thus assist users in estimating the level of future impairment losses (IFRS 7 paragraph BC55a). The analysis showed that about one fifth of companies did not provide such disclosures (as shown in figure 9); for FTSE Eurotop companies the level of compliance was somewhat better.

The disclosure shall include an analysis of financial assets that are individually determined to be impaired at the reporting date and the factors that were considered in determining that those assets were impaired (IFRS 7 paragraph 37b). Such an analysis may include the carrying amount, before deducting any impairment losses, the amount of any related impairment losses, and the nature and fair value of collateral available and other credit enhancements obtained (IFRS 7 paragraph IG29). An analysis of impaired financial assets other than by age is useful because it helps users to understand why the impairments occurred.

The analysis showed that entities often provide more information about the financial assets that are individually determined to be impaired at the reporting date (with 15% of all companies, and 5% of FTSE Eurotop companies not doing so) than about financial assets that are past due but that are not impaired. However, with regard to disclosure of the description of collateral held by the entity as security or other credit enhancements and an estimate of their fair value, CESR noted that about 35% of all the companies sampled and a similar percentage of FTSE Eurotop companies did not disclose this information.

It is also noted that up to 30% of entities did not disclose by class of financial asset the carrying amount of financial assets that are renegotiated but that would otherwise have been past due or impaired.

CESR would have expected that significantly more issuers would have provided disclosures related to credit risk as we consider these the most important ones for financial companies. CESR notes that for future reporting periods, in addition to the mandatory disclosures contained in IFRS 7, the non-mandatory disclosures recommended by the Senior Supervisors Group may become relevant.

4.3 Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulties in meeting obligations arising from financial liabilities that are settled by delivering cash or another financial asset. Liquidity risk also arises because of the possibility that the entity could be required to pay its financial liabilities earlier than expected. Disclosure of a maturity analysis for all financial liabilities at the reporting date showing the remaining contractual maturities for all financial liabilities together with a description of how the entity manages that liquidity risk is required by IFRS 7 paragraph 39.

CESR's analysis focused on the disclosures related to liquidity risk in line with the current definition in IFRS 7 of financial liabilities. In addition to the qualitative and quantitative disclosures on liquidity risk required in IFRS 7 paragraph 33-35 discussed above, our analysis showed that almost all companies disclosed the maturity analysis of liabilities by contractual maturity required by IFRS 7 paragraph 39. A maturity analysis helps users of financial statements to asses the nature and extent of liquidity risk, together with a description of how issuers manage their liquidity risk.

As noted earlier, the IASB issued its final amendment to IFRS 7 – *Improving Disclosures about Financial Instruments* in March 2009, with enhanced disclosure requirements for maturity analysis in relation to liquidity risk. As these amendments were issued in 2009 and not endorsed for mandatory application in the European Union for the 2008 financial statements, CESR has analysed whether companies applied these amendments on a voluntary basis in 2008. The results are shown in figure 10 below.

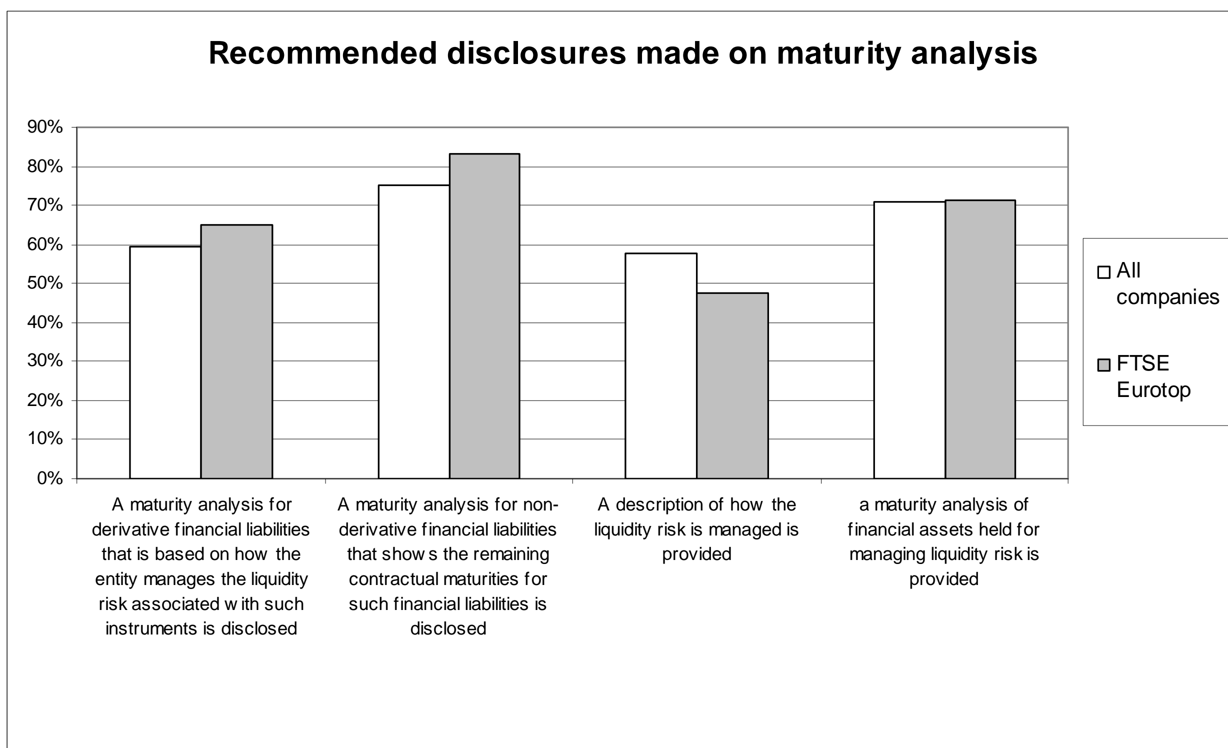

Figure 10: Recommended disclosures made on maturity analysis (ED March 2009)

The analysis shows that if the amendment had been in force for 2008 financial statements:

- Around 80% of the companies sampled would have been required to:
    - Disclose a maturity analysis for derivative financial liabilities that is based on how the company manages the liquidity risk associated with such instruments. Of those companies around 60% did give such disclosures. Amongst FTSE Eurotop companies the figure rose to 70%;

  - o Disclose a description of how the company managed the liquidity risk inherent in derivative and non-derivative financial liabilities. About half of those companies (and a similar proportion of FTSE Eurotop companies) disclosed such a description.

- Around two thirds of the companies sampled would have been required to:
  - o Disclose a maturity analysis for non-derivative financial liabilities that show the remaining contractual maturities for such financial liabilities. Of those companies around 70% did give such disclosures. Amongst FTSE Eurotop companies the figure rose to 80%.
  - o Disclose a maturity analysis of financial assets held for managing liquidity risk if that information is necessary for users to evaluate the nature and extent of liquidity risk. Of those companies around 70% (and a similar proportion of FTSE Eurotop companies) disclosed such a maturity analysis.

Overall, CESR notes that a relatively high number of companies has chosen to early adopt the amendment to IFRS 7 in their financial statements of 2008 relating to disclosures regarding liquidity risk.

4.4 Market risk

During the financial crisis, markets experienced periods of particularly high volatility and uncertainty. In light of this volatility, disclosures relating to the market risk of financial instruments became important for users in understanding the impact of this risk on the financial statements. As defined in IFRS 7 market risk is the risk that the fair value or the future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risks which are: currency risk, interest rate risk and other price risk.

The CESR analysis on market risk disclosures focused on the mandatory disclosure requirements in IFRS 7 paragraphs 40-42. Market risk sensitivity analysis is required for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at the reporting date. In addition, disclosure of the methods and assumptions that were used in preparing the sensitivity analysis, any changes from the previous period in the methods and assumptions used, and the reasons for those changes, is required (IFRS 7.40). This sensitivity analysis provides useful information since it is relatively easy to calculate and understand, is suitable for all entities and highlights the nature and extent of risks that arise from financial instruments (IFRS 7 paragraph BC59).

The analysis showed that almost all companies provided disclosures related to sensitivity analysis on market risk either in accordance with paragraph 40 or 41 of IFRS 7. These disclosures regarding sensitivity analysis are required to be provided as either:
- showing how income or equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date (IFRS 7 paragraph 40); or
- an explanation of the method and of the main parameters and assumptions if the entity uses a sensitivity analysis that reflects interdependencies between variables (e.g. interest rate and exchange rate) and uses that analysis to manage financial risk in accordance with IFRS 7 paragraph 41.

The analysis also showed that more than half of all companies provided disclosures in accordance with IFRS 7 paragraph 40 and more than half of all companies provided disclosures in accordance with IFRS 7 paragraph 41. The results for FTSE Eurotop companies show that around three quarters provide the disclosures in accordance with IFRS 7 paragraph 40 or IFRS 7 paragraph 41. In general, issuers had complied with the disclosure requirements on market risk.

Around one third of all companies concerned provided both set of disclosures. For the FTSE Eurotop companies around half did.

5. Special Purpose Entities (SPEs)

5.1 Special Purpose Entities

In response to the global financial crisis the Financial Stability Forum asked the Senior Supervisors Group (SSG) to perform a review of disclosure practices for certain exposures, including those arising from Special Purpose Entities (SPEs) – including Collateral Debt Obligations (CDO), Asset-Backed Commercial Paper (ABCP), Structured Investment Vehicles (SIV) and a variety of others SPEs. The results are set out in the SSG's publication "*Leading-Practice Disclosures for Selected Exposures*".

Mandatory disclosures

Current IFRS requirements regarding special purpose entities are set out in IAS 27 – Consolidated *and Separate Financial Statements* and in SIC 12 – *Consolidation – Special Purpose Entities*. CESR is not aware of any major deficiencies arising from the current application of IAS 27 and SIC 12. However, in the light of the financial crisis, the role that consolidation could have played in financial reporting and the proposed IASB amendments, CESR focused especially on the disclosure requirements related to SPEs.

The analysis showed that around 40% of the companies analysed did not have any SPEs controlled by the entity. Of the remainder, around 20% did not disclose their judgement exercised relating to the decision whether the substance of the relationship between the entity and a SPE indicated that the SPE was controlled by that entity (IAS 1.113-114d).

60% of the entities reviewed had controlled SPEs. Therefore they had to disclose the nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances[24]. Of those having to make such disclosure, half of them did not. CESR believes that disclosures related to SPEs are important for users, informing them of the extent to which entities are closely linked to the reporting entity, and would have consequently expected more compliance.

Additional guidance on disclosures

The IASB decided to accelerate its project on consolidation and issued ED 10 in December 2008. The main objective of the project was to improve the definition of control and related application guidance so that a control model could be applied to all entities, and to improve the disclosure requirements related to consolidated and unconsolidated entities[25]. CESR briefly analysed whether companies incorporated the new disclosure requirements suggested in ED 10 *Consolidated Financial Statements* in their financial statements for 2008. The analysis showed that the disclosures items suggested in ED 10 were not yet widely applied by the companies analysed. However, it should be noted that the ED was published late 2008, that it was not mandatory for use in the European Union for 2008 year-ends and that it was at the time still in the consultation phase.

CESR also examined whether companies had chosen to include the disclosures recommended by the Senior Supervisors Group in relation to SPEs.

[24] IAS 27 paragraph 40d
[25] A final standard is expected to be published in the fourth quarter of 2009.

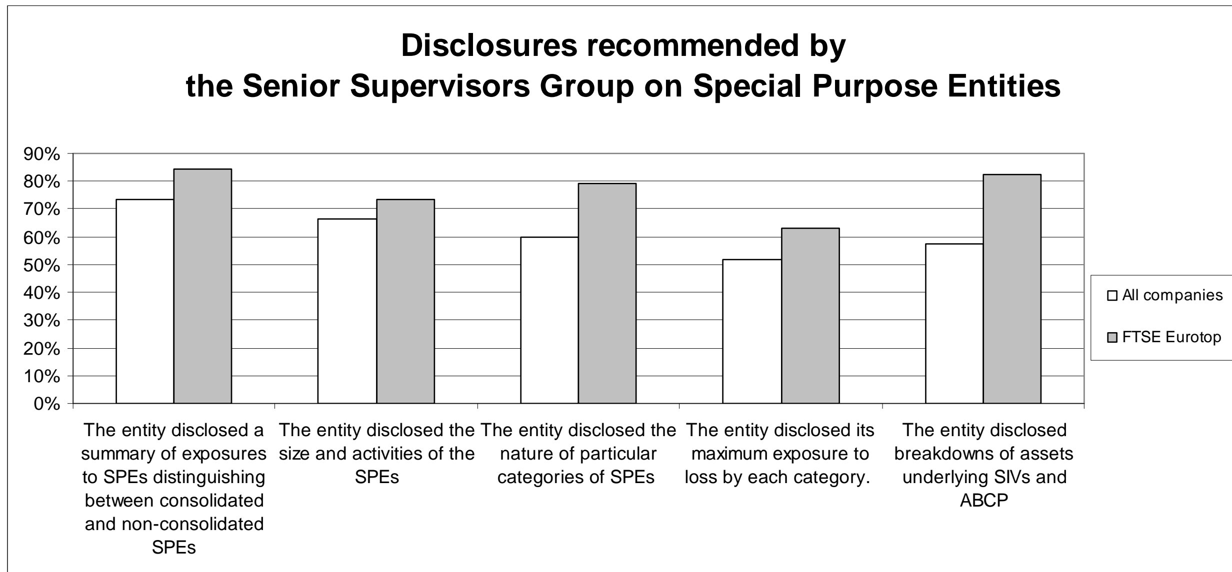

Figure 11: Disclosures on Special Purpose Entities recommended by the Senior Supervisors Group

CESR notes that a greater proportion of FTSE Eurotop companies provided these disclosures items compared to the entire set of companies analysed. The greater use of SPEs by such companies and the greater significance of the role, size and of the transactions of and with SPEs may be the primary reason for this.

The analysis specifically showed that:

- Around 70% of all companies and more than 80% of the FTSE Eurotop-companies disclosed a summary of their exposures to the SPEs with which they were involved, distinguishing between those SPEs that were and were not consolidated. These exposures generally included CDOs, ABCPs, SIVs and a variety of other SPEs. Circumstances that require a particular SPE to move from off-balance-sheet to on-balance-sheet were noted;
- Almost 70% of all companies and more than 70% of FTSE Eurotop companies disclosed the size and activities of the SPEs concerned;
- Around 60% of all companies and almost 80% of FTSE Eurotop companies disclosed the nature of particular categories of SPEs (such as sponsor, liquidity and/or credit enhancement provider);
- More than half of all companies and about 80% of FTSE Eurotop companies disclosed their maximum exposure to losses as a result of their involvement with each category of SPE.

5.2 Off balance sheet items

According to IAS 1 paragraph 113 an entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

In addition IFRS 7 paragraph 13 (a) and (b) require that an entity that may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition disclose the nature of the assets and the nature of the risks and rewards of ownership to which the entity remains exposed for each class of such financial asset.

The figure below shows the proportion of companies that did not provide these mandatory disclosures as required in IAS 1 paragraph 113-114 and IFRS 7 paragraph 13 (a) and (b).

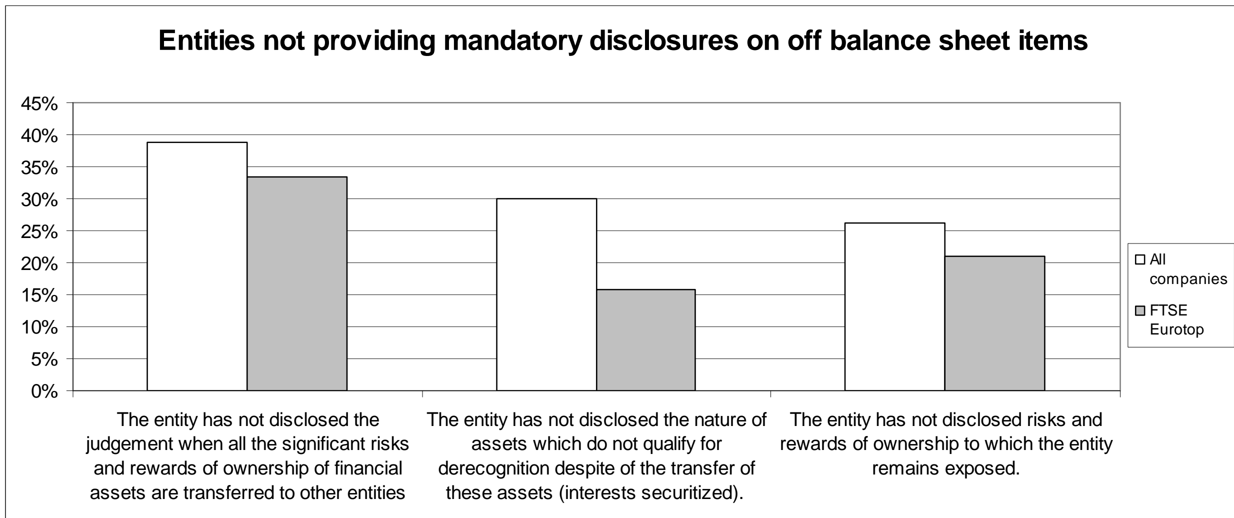

Figure 12: Number of entities not providing mandatory disclosures on Off balance sheet items

Around 40% of companies with SPEs did not disclose their reasons for deciding that all the significant risks and rewards of ownership of financial assets had been transferred to other entities as required by IAS 1 paragraph 113 and 114. About 30% of the companies did not disclose the nature of assets which did not qualify for derecognition despite the transfer of those assets (interests securitized) and details of the risks and rewards of ownership to which the entity remained exposed (IFRS 7 paragraph 13).

Around 25% of all companies and 65% of FTSE Eurotop-companies disclosed breakdowns of the assets underlying the structured investment vehicle and asset-back commercial paper conduits by collateral type, credit rating and location of the ultimate borrowers and the average maturity of the borrowers' obligations.

CESR would have expected that the proportion of companies not providing sufficient disclosures regarding their activities with off balance sheet entities to have been much lower as this information is highly relevant to understanding the financial statements.

6 Impairment

Where financial assets are impaired by credit losses and the entity records the impairment in a separate allowance account rather than by directly reducing the carrying amount of an asset, the entity is required to disclose a reconciliation of changes in that account during the period (IFRS 7 paragraph 16). This disclosure should be done by each class of financial asset. Reconciliation is useful in assessing the adequacy of the allowance for impairment losses and enables comparison between companies. However, IFRS 7 does not specify the components of the reconciliation. As impairment on financial assets can be determined differently by one entity compared to another, preparers are given flexibility in determining the most appropriate format for their needs (IFRS 7 paragraph BC26). In addition, an entity should disclose any impairment loss for each class of financial assets according to IFRS 7 paragraph 20 and is given application guidance in IFRS 7 paragraph B5.

The analysis showed companies (FTSE Eurotop and non-FTSE Eurotop companies) complied to a great extent with the disclosure requirements in IFRS 7 regarding the impairment of financial instruments.

It is important for users to understand the criteria an entity uses to determine if there is objective evidence that an impairment loss for an available for sale equity instrument has occurred[26]. CESR noted that around 80% of all companies analysed (90% of the FTSE Eurotop companies) had impairment losses for financial instruments in 2008. A small proportion of companies which should have done so (around 5%) did not disclose the accounting policies in this regard, including the criteria they used to determine that there is objective evidence that an impairment loss has occurred for equity instruments classified as available for sale.

7 Audit

The CESR analysis considered the audit opinion contained in the financial statements. 2% of the companies sampled had a modification relating to a non compliance with IFRS while around 10% contained an emphasis of matter paragraph; around half of these emphasis of matter paragraphs related to going concern issues in the context of the financial crisis, and the remainder related to various other specific issues.
CESR performed no work to asses how the auditors concerned may have reached their opinion.

8 Enforcement

As stated previously, the data compiled for this analysis was provided by the European national enforcers. The financial statements of all the entities concerned were reviewed solely for the purpose of this analysis, and the results should consequently be considered entirely separately from any enforcement actions contemplated or which may at some point in the future actually be undertaken by national enforcers. CESR will continue in its role of co-ordinating European enforcement decisions and will organise discussions relating to any enforcement actions resulting from the issues contained in this report.

9 Next steps

As an organisation of securities regulators and enforcers of IFRS in Europe, CESR will continue to monitor closely future developments in the area of financial instruments and fair value accounting. CESR will also consider which areas of IFRS and its application would be of particular interest to market participants bearing in mind market conditions and any other developments regarding accounting standards.

[26] IFRS 7.B5f