COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date 26 October 2010

Ref.: CESR/10-1183

CESR STATEMENT

Follow-up Statement on Application of Disclosure Requirements Related to Financial Instruments in the 2009 Financial Statements

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EXECUTIVE SUMMARY

The purpose of this Statement is to provide an update on the CESR Statement "Application of Disclosure Requirements Related to Financial Instruments in the 2008 Financial Statements of financial institutions" (hereafter "CESR Statement 09-821").

In accordance with its commitment to report to the market on the subsequent developments in this area, CESR is pleased to present the main conclusions derived from European enforcers' analysis of the actions taken and their indirect effect on the 2009 IFRS financial statements.

As part of their supervisory role in relation to listed companies, European enforcers took various types of actions on the infringements identified in the 2008 IFRS financial statements, based on materiality, relevance to the issuer and the legal powers available to the enforcers in each country. As such, around 250 issuers have been subject to actions taken by enforcers, out of which 28 of the issuers were included in the sample of financial institutions reviewed for the purpose of CESR Statement 09-821. Enforcers supplemented such measures by alerting issuers on areas to be closely monitored in the process of the preparation of the 2009 IFRS financial statements.

CESR is pleased to announce that the results of the review performed on the 2009 IFRS financial statements of the financial institutions included in the sample indicate significant improvements in the level of compliance of disclosures related to: valuation techniques, own credit risk, credit risk, day one profit or losses and special purposes entities. Other areas have also seen some improvement. The amendments to IFRS 7, mandatory for the periods started after 1 January 2009, and designed to provide information on the fair value hierarchy used by the companies have also seen a high level of compliance.

CESR welcomes all these improvements while strongly encouraging financial institutions to continue to enhance or maintain their levels of transparency in the future.

Introduction

In October 2009, CESR issued a Statement, "Application of Disclosure Requirements Related to Financial Instruments in the 2008 Financial Statements of financial institutions" (hereafter "CESR Statement 09-821"). The objective of the paper was to analyse the level of compliance with mandatory disclosures related to financial instruments, as set out in IFRS 7 "Financial Instruments: Disclosures" as well as with a number of other disclosures recommended by certain other authoritative bodies. The results of the study highlighted that compliance could be improved in certain areas to enhance the transparency of financial communication to the market.

As announced in its Statement last year, and consistent with its role of co-ordinating enforcement activities in Europe, CESR has continued to monitor closely developments in relation to the reporting of financial instruments, including actions taken by different EU enforcers in respect of the accounts that were reviewed last year. In producing this follow-up report, CESR reports on the specific actions taken, the levels of compliance in the areas surveyed and the enhancements to the mandatory disclosures required for financial instruments in the 2009 IFRS financial statements of EU issuers.

As indicated above, CESR Statement 09-821 covered both mandatory and recommended disclosures relating to financial instruments in the accounts of financial institutions. As enforcers can take actions against companies in respect of reporting infringements only in respect of IFRS mandatory disclosures, this follow-up report focuses on:

- Measures taken by enforcers to improve areas of non-compliance with IFRS mandatory requirements identified in the 2008 IFRS financial statements; and
- An analysis of improvements made by a sample of issuers in respect of their 2009 IFRS financial statements.

1. Measures taken by European enforcers

Specific actions taken in respect of 2008 IFRS Financial Statements.

As previously explained, the purpose of this Statement is to provide an update to CESR Statement 09-821. It reports on the actions taken by EU enforcers in respect of potential infringements detected in CESR's review of financial instrument disclosures in the accounts of the 96 issuers selected last year and provides an overview of the improvements in the equivalent disclosures in their 2009 accounts.

On the basis of the information gathered from European enforcers, infringements reported in CESR Statement 09-821 related mainly to the application of IFRS 7 mandatory requirements in the following areas: credit risk, fair value and valuation techniques, sensitivity risk, and impairment of financial assets. It should be noted that this Statement, for the most part, is reporting findings on the basis of a desk top review of the accounts. Whether any action should have been taken in respect of identified infringements in the individual company accounts rested with the individual EU enforcers.

The potential infringements have since been followed by specific actions, the nature of which was determined based on their relevance and materiality to the issuers' financial statements. Based on the information communicated by the European enforcers, the number of issuers subject to action by enforcers is detailed below by type of action:

Type of action	Number of issuers in the scope of CESR Statement 09-821	Out of which FTSE Eurotop 100 companies
Action requiring issuance of public corrective note or press release	3	-
Action requiring correction or improvements in future financial statements	11	2
Message to issuer without corrective note	12	5
Other action	2	-

A number of EU enforcers, of course, also reviewed the 2008 accounts of other financial institutions not included in the original sample. As the relevant standards apply also to the accounts of non financial institutions, enforcers asked a number of other listed issuers about their compliance with various aspects of the reporting requirements although the nature of the questions relating to financial instruments tends to have a different focus for these issuers than for financial institutions.

The result of such exercises performed by European enforcers indicates that:

- 51 issuers have been required to issue public corrective note or a press release.
- 73 companies have been required to correct or improve in future financial statements.
- 114 entities have received messages without requiring corrective note.
- 8 issuers have been subject to other actions

Specific actions taken to influence the preparation of 2009 IFRS Financial Statements

In addition to enforcement actions taken in respect of infringements detected in 2008 financial statements, some enforcers drew the market's attention to the significance of financial instruments' disclosure in order to influence issuers' preparation of their 2009 IFRS financial statements.

Enforcers drew particular attention to the amendments to IFRS 7 in March 2009, endorsed by the European Union in November 2009 and applicable for financial periods starting on or after 1 January 2009. Around half of the European enforcers alerted their issuers through public announcement to the particular relevance of disclosure in key areas, such as:

- fair value hierarchy including valuation techniques and unobservable inputs
- impairment of financial assets
- liquidity risks disclosures

2. Analysis of developments in financial instruments' disclosure

In order to provide the market with an overall assessment of any improvement in financial instruments disclosure and to report on the specific actions taken by EU enforcers in respect of infringements in the 2008 accounts of the sampled financial institutions, CESR asked members of the European Enforcement Coordination Sessions (hereafter "EECS") to assess compliance in a number of areas in the 2009 financial statements.

The analysis performed this year was conducted on the same sample of entities as the CESR Statement 09-821 in order to maximise comparability. The intention was that the 96 companies selected would provide an appropriate reflection of the distribution of financial companies (banks and insurers) within the European market; 22 of the entities in the sample are included in the FTSE Eurotop 100 companies.

As far as this report is concerned, the 2009 IFRS financial statements were reviewed solely for the purpose of considering financial instruments disclosure. The analysis concentrates on the areas where a low level of compliance was reported in CESR Statement 09-821.

It should be noted that the analysis presented involves a high degree of judgment in some areas and that the materiality of disclosures is a factor that needs to be taken into account when considering the appropriateness of enforcement actions and other measures.

Overall results of review

The results of the 2009 review with respect to mandatory disclosures on financial instruments as required by IFRS 7 shows improvement in all monitored areas. The most significant increase in the level of compliance relate to: valuation techniques, own credit risk, credit risk, day one profit or losses and special purpose entities. A high level of compliance is also reported in respect of the new requirements relating to fair value hierarchy, mandatory for the first time in the December 2009 accounts. CESR welcomes all of these improvements while strongly encouraging financial institutions to continue to maintain and, improve the level of such disclosures in the future.

As previously indicated, EU enforcers assessed the level of compliance with all mandatory disclosures required by IFRS 7. For the purpose of this Statement, the areas are categorised:
- Areas of significant improvement,
- Areas of some improvement,
- New areas under review.

A summary of the overall and detailed assessment is presented in the table below. The new areas are not included here since the comparison of the level of compliance between 2008 and 2009 is not relevant.

Areas assessed as having overall "significant improvement"

Technical area	**% of compliance**		**Detailed improvement assessment**
	In 2009 F/S	**In 2008 F/S**	
Valuation technique (see 2.1.1)			
Valuation technique used	95%	85%	Some
Change of fair value (level 3)	80%	55%	Significant
Sensitivity of fair value changes	80%	60%	Significant
Own credit risk (see 2.1.2)			
Changes due to own credit risk	85%	70%	Significant
Variance book value and amount to be paid at maturity	75%	65%	Some
Methods used to determine own credit risk	80%	60%	Significant
Disclosures do not faithfully represent change in FV etc.	60%	30%	Significant
Credit risk (see 2.1.3)			
Various disclosures	70-90%	60-75%	Significant
Day one profits or losses (see 2.1.4)			
Required disclosures	70%	50%	Significant
Special Purpose Entities ("SPE") (see 2.1.5)			
Judgment relating to control of SPEs	90%	80%	Some
Significant restrictions	75%	50%	Significant

Areas assessed as having overall "some improvement"

Technical area	% of compliance		Detailed improvement assessment
	In 2009 F/S	In 2008 F/S	
Sensitivity analysis (see 2.2.1)			
Accounting policies judgments etc	80%	75%	Some
Key assumptions	85%	80%	Some
Impairment of available for sale equity instruments (see 2.2.2)			
Objective evidence	90%	80%	Some
Off balance sheet items (see 2.2 3)			
Reasons for deciding risks and rewards transferred	80%	60%	Significant
Nature of the assets that did not qualify for de-recognition	80%	70%	Some
Risk and rewards retained	85%	75%	Some

Detailed results of the analysis

2.1 Areas of significant improvement

2.1.1 Valuation techniques

Significant improvement has been identified in this area.

The amendments introduced to IFRS 7 for 2009 year-ends stressed the importance of disclosing the assumptions adopted in valuation techniques.

EECS analysis shows that 95% (2008: 85%) of all companies (around 95% compared to 90% in the previous period of FTSE Eurotop companies) disclosed whether fair values 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 27A).

The change in fair value estimated using a valuation technique that was recognised in profit or loss during the period (IFRS 7 paragraph 27B (c)) was disclosed by 80% (2008: 55%) of companies.

A significant improvement was identified in 2009 in the accounts of those entities which disclosed the sensitivity of fair values to changes in the assumptions used in the determination of those values. Around 80% (2008: 60%) of the companies complied with this requirement (IFRS 7 paragraph 27 (e)).

2.1.2 Own credit risk

Disclosures related to own credit risk significantly improved in 2009.

For financial liabilities designated as at fair value through profit or loss, IFRS 7 (paragraph 10 and 11 and B4-B5) requires an entity to make certain disclosures on the amount of any change in a liability's fair value that is attributable to changes in the entity's own credit risk. The analysis showed that both 80% (2008: 75%) of all companies taking this option and of FTSE Eurotop-companies sampled designated a financial liability at fair value through profit or loss in accordance with IAS 39.

The 2009 review revealed a significant increase in the level of compliance with the IFRS 7 requirements indicating that:

- around 85% (2008: 70%) of the companies which used the fair value option disclosed 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;
- around 75% (2008: 65%) disclosed information on 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;
- around 80% (2008: 60%) disclosed 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;
- around 60% (2008: 30%) provided a rationale for concluding that, having given the disclosures considered above, that they 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 the remaining 40% in the sample, it is not possible to determine whether the disclosures were relevant or material.

Of the 22 FTSE Eurotop companies in the sample, 20 were compliant with the requirements in the different areas indicated above.

2.1.3 Credit risk

The results of the 2009 review indicate a significant improvement in credit risk disclosures compared to the previous year.

IFRS 7 disclosures about credit risk are intended to provide the user with an overview 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. In the review of the 2008 financial statements, CESR identified a level of compliance ranging from 60% to 75% with respect to specific disclosures required under IFRS 7 paragraphs 36 and 37. CESR considers these disclosure requirements to be one of the most important reporting areas for financial institutions and is pleased to note the significant improvements made.

In assessing the level of disclosures in the same area in the 2009 financial statements, the level of - compliance increased to levels ranging from 70% to 90%. A significant improvement is identified in 2009 in the area relating to the disclosures regarding impairment of assets, where more entities disclosed the carrying amounts of financial assets that would be past due or impaired, or whose terms have been renegotiated, and those past due, but not impaired (IFRS 7 paragraph 37 (a)).

2.1.4 Day one profit or loss

The level of disclosure relating to day one profit or loss significantly improved in 2009.

IFRS 7.28 requires disclosure of the accounting policy on treatment of day one profit or loss by class of financial assets and also quantitative information on the amount yet to be recognized together with the amount previously deferred and a reconciliation of opening and closing balances.

In 2009, 70% of the entities under review (2008: 60%) disclosed their accounting policy related to the recognition of day one profit or losses for each class of asset. The level of compliance on quantitative information significantly increased in the year, indicating that 70% of the entities provided the required disclosures, compared to only 50% the previous year. Although the improvement in companies making the required disclosures in this area is significant, CESR would still encourage more institutions to comply.

2.1.5 Special Purpose Entities ("SPE")

Some improvement has been identified in disclosing the nature of the relationships between an entity and its SPE. Significant improvement has been seen with respect to disclosure of significant restrictions existing between entities and SPE.

As the scope of IFRS 7 in relation to the accounts of financial institutions is highly reliant on the extent of consolidation, specific requirements from IAS 27 – *Consolidated and Separate Financial Statements* and SIC 12 – *Consolidation – Special Purpose Entities* were considered as part of the overall review exercise in both years.

The analysis showed that around 65% (2008: 60%) of the companies included in the review had SPEs within their control. Out of these companies, around 90% (2008: 80%) disclosed the judgement exercised by management in deciding whether the substance of the relationship between the entity and the SPE indicated that the SPE was controlled by that entity (IAS 1 Revised 122).

The level of compliance relating to disclosure of the nature and extent of any significant restrictions existing between the entity and its SPE improved in 2009, with 75% (2008: 50%) of companies complying with those requirements. The balance may not have had any significant restrictions.

2.2 Areas of some improvement

2.2.1 Sensitivity analysis

There was further improvement in this area which saw a fairly high degree of compliance in the original review.

This section refers to the general requirements of IAS 1 Revised (paragraphs 122 and 125-136) with respect to the sensitivity of fair value estimates in the case of changes in assumptions used in the fair value measurement of financial assets and liabilities recognised through profit and loss. The results of the analysis indicate some improvement in compliance with disclosure requirements

- 80% (2008: 75%) of companies and 95% (2008: 90%) of those from the FTSE Eurotop100 disclosed either in the summary of significant accounting policies or other notes, the judgements that management had made in the process of applying the entity's accounting policies and that had had the most significant effect on the amounts recognised in the financial statements.
- 85% (2008: 80%) of companies and 95% (2008: 90%) of FTSE Eurotop100 entities appropriately disclosed key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, which had a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the following financial year.

2.2.2 Impairment related to available-for-sale equity instruments

Some improvement was identified in this area.

In the context of the financial crisis it is important for users to understand the criteria used by an entity to determine if there is objective evidence that an impairment loss on an available for sale equity instrument has occurred (IFRS 7 paragraph B5f).

In 2009, almost 80% (2008: 80%) of the entities under review recognised impairment losses in their accounts relating to available for sale equity instruments. Disclosure of objective evidence relating to impairment loss saw also some improvement, with 90% of companies in the sample providing the appropriate disclosures (2008: 80%).

2.2.3 Off balance sheet items

While significant improvement has been identified in the disclosure of the reasons for deciding on the risks and rewards transferred, disclosure about the nature of the assets remaining under the entity's control saw only some improvement.

According to IAS 1 Revised (paragraph 122- 123b) 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 paragraphs 13 (a) and (b) require that an entity that has transferred financial assets in such a way that part or all of the financial assets do not qualify for de-recognition 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.

In 2009 around 80% (2008: 60 %) of companies with SPEs disclosed the reasons for deciding that all the significant risks and rewards of ownership of financial assets had been transferred to other entities.

About 80% (2008:70%] of the companies disclosed the nature of assets which did not qualify for de-recognition despite the transfer of those assets. Around 85% (2008: 75%) of all companies disclosed the nature of the risks and rewards to which the entity remained exposed. CESR would have expected a higher proportion of companies to provide sufficient disclosures regarding their activities with off balance sheet entities as this information is highly relevant to an understanding of the financial statements.

2.3 New areas under review

2.3.1 Fair value hierarchy and valuation techniques

This area has become mandatory for the financial periods starting after 1st of January 2009. The results of the review indicate a high level of compliance.

In October 2008, as part of the convergence project between US GAAP and IFRS regarding disclosure about the fair value hierarchy, the IASB published amendments to IFRS 7. The amendments have been endorsed in Europe and are mandatory for financial periods starting on or after 1 January 2009. The amendments introduced require entities to classify fair value measurements using a fair value hierarchy, depending on the source of inputs used for measurement. The fair value hierarchy consists of three levels:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs, other than quoted prices included within Level 1, that are observable for the asset or liability, either directly or indirectly; and
- Level 3 – Inputs for the asset or liability not based on observable market data.

CESR is pleased to report that 90% of the financial institutions provided the relevant disclosures in their 2009 financial statements. The detailed results of the review indicate the following:

- Around 95% of the entities disclosed the fair value information using the fair value hierarchy (level 1, 2 and 3)
- Regarding transfers between level 1 and level 2, 80% of the companies provided this information
- Reconciliation of changes in level 3 assets: the level of entities complying with different requirements in this area varies from 90% %to 95%, indicating a high level of compliance

20 entities from the 22 FTSE Eurotop 100 companies in the sample were compliant with the requirements.

The fair value hierarchy focuses on the methods used to determine the fair value and the inputs used in valuation techniques rather than the techniques themselves. While the availability of inputs might affect the valuation technique selected to measure fair value, IFRS 7 does not provide specific guidance as to how an entity should determine the significance of individual inputs and to prioritise the use of one technique over another. This assessment requires judgment and consideration of factors specific to the asset or liability (or group of assets and/or liabilities) being measured. In many cases, the use of sensitivity analysis or stress testing may be appropriate approaches to assess the effects of changes in unobservable inputs on a fair value measure.

In CESR Statement 09-821, this area was analysed as part of the recommended disclosures since the amendment was not yet in force. CESR was very pleased to report that, although not yet a required disclosure, 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 then Exposure Draft.

2.3.2 Liquidity risk

Overall the level of compliance was maintained, although enforcers identified some issuers who reported on the basis of discounted cash-flows and which, therefore, are not in compliance with IFRS 7

As noted earlier, the IASB issued its final amendments to IFRS 7 – *Improving Disclosures about Financial Instruments* in March 2009, with enhanced disclosure requirements for maturity analysis in relation to liquidity risk, applicable for companies for financial periods starting on or after 1 January 2009. The amended version refines the requirement to provide a maturity analysis, specifying that separate maturity analyses are required for derivative and non-derivative financial liabilities. The standard is now clear on the fact that non-derivative financial liabilities shall include guarantee contracts issued by the entity (IFRS 7.39 (a)) and that the analysis of the contractual maturity of derivative instruments shall include derivative contracts whose contractual maturities are essential for understanding the timing of future cash-flows (IFRS 7.39 (b)).

In disclosing summary quantitative data about exposure to liquidity risk, the amendments require an entity to explain how those data are determined. An entity is required to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative liquidity risk disclosures.

The review of disclosures relating to liquidity risk reveal that this area saw a very high level of compliance in the previous period, with almost all companies disclosing the maturity analysis of the liabilities by contractual maturity. While a similar level was also identified in the 2009, it was noticed that there are some issuers disclosing the discounted cash-flows rather than the undiscounted cash-flows as required by the standard.