Practical Workshop NBU

Putting it all together: IAS 32 and IFRS 7

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Outline

IFRS 7 Disclosures

- » Overview IFRS 7
- » IAS 1 Disclosure requirements
- » Disclosure requirements credit risk
- » Disclosure requirements market risk
- » Examples credit risk and market risk disclosures

IFRS 7 Disclosures

- This presentation covers IFRS 7 Disclosures and focuses mainly on market and credit risk
- This section includes an overview of IFRS 7 and practical examples of disclosures

IAS 32 Financial Instrument: Presentation

» Most of IAS 32 has been replaced by IFRS 7

» IAS 32 now deals only with the classification of a financial asset

» An financial instrument needs to be classified as:

  » a financial asset

  » a financial liability

  » an equity instrument

» The standards mostly deals on how to differentiate equity and liabilities. For example redeemable share issued:

  » If it has a mandatory date of reimbursement: liability

  » In can be redeemable only: equity (no mandatory obligation to transfer cash or a financial asset)

IFRS 7 disclosures

Overview – IFRS 7

- IFRS 7 issued in 2005 and replaced IAS 30 and IAS 32
- IFRS 7: Disclosures about all financial instruments
- IFRS 7 disclosure requirements incorporated many of the requirements of IAS 32
- There are exceptions: such as pensions, insurance contracts, etc.
- Applicable to all entities even if they have only a few financial instruments
- But the extent of disclosure required depends on their use of financial instruments and exposure to risk

Overview – IFRS 7

» Qualitative and quantitative disclosures i.e. words and numbers

» The IASB believes that users of financial statements need information about an entity's exposure to risks and how those risks are managed

» Disclosures in IFRS 7 are around 3 main areas: Credit risk, market risk and liquidity risk

Amendments to IFRS 7

- A number of amendments made to IFRS 7 pre and post crisis
- March 2009 – enhanced disclosures about fair value measurements and liquidity risk
- October 2010 – transfers of financial assets – to help users of financial statements evaluate the risk exposures relating to transfers of financial assets and the effect of those risks on an entity’s financial position

IAS 1 Disclosure requirements

- IAS 1 also include a number of key disclosure requirements:
  - Summary of significant accounting policies
  - Measurement basis
  - Accounting policies used that are relevant to an understanding of the financial statements

- The disclosure requirements in IAS 1 are directly related to the disclosure requirements in IFRS 7

IFRS 7 disclosure requirements

- According to IFRS 7: Providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and form and overall picture of the nature and extent of risks arising from financial instruments
- According to IFRS 7: The interaction between qualitative and quantitative disclosures contributes to disclosures in a way that better enables users to evaluate an entity’s exposure to risk
- What does the above mean?
  - Important that words and numbers complete each other and are meaningful to users
  - Words explain the numbers
  - Words should be relevant and not “boiler-plate”
  - Words should be contextual

IFRS 7 disclosure requirements

- Qualitative disclosures (for market, credit and liquidity risk)
  - For each type of risk arising from financial instruments, an entity shall disclose:
    - The exposures to risk and how they arise
    - Its objectives, policies and processes for managing the risk and the methods used to measure the risk
    - Any changes from previous periods

IFRS 7 disclosure requirements

- Classes of financial instruments and level of disclosure
  - When disclosure requirements are by class of financial instruments, an entity shall group them by 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
- Implications
  - Users should be able to see the trail from notes to statement of financial position and vice-versa
  - Information should be sufficiently detailed ie too much aggregation not useful
  - Not to confuse between classes and categories (4 in IAS 39)

IFRS 7 disclosure requirements – Credit risk

- By class of financial instruments
  - The amount that best represent its maximum exposure to credit risk without taking into account collateral
  - Description of collateral held as security
  - Information about credit quality of financial assets that are neither past due nor impaired
  - For either past due or impaired financial assets:
  - An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and
  - 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
  - If collateral meets the recognition criteria in other IFRSs, an entity shall disclose the nature and carrying amount of the assets

IFRS 7 disclosure requirements – Credit risk

- Credit risk: the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation

- Past due: a financial asset is past due when a counterparty has failed to make a payment when contractually due

IFRS 7 disclosure requirements – Credit risk

» Disclosures required for credit risk (and also market and liquidity risk) should be given in the financial statements or incorporated by cross-reference from the financial statements to management commentary or risk report available to users of the financial statements

» Without the information incorporated by cross-reference, the financial statements are incomplete

» When management uses several methods to manage risks, the entity shall disclose information using the method or methods that provide the most relevant and reliable information

IFRS 7 disclosure requirements – Market risk

» Market risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises 3 types of risk: currency risk, interest rate risk and other price risk

» Currency risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates

» Interest rate risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates

» Other price risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than interest rate or currency risk) e.g. equity or commodity

IFRS 7 disclosure requirements – Market risk

- Sensitivity analysis
- To reflect the impact of market risk on the valuation of the financial instruments, the entity shall disclose a sensitivity analysis for each type of market risk, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date
- To disclose: Methods and assumptions used in preparing the sensitivity analysis
- To disclose: Changes from previous period in the methods and assumptions used and reasons for such changes

IFRS 7 disclosure requirements – Market risk

» Sensitivity analysis is a kind of stress test with less radical assumptions

» Although supervisors may have access to more detailed data re. sensitivity analysis or may require firms to perform more stringent tests on the impact of market risks on profit and loss and capital, the IFRS 7 disclosures on market risk is a good place to start

» Supervisors can also review these disclosures to check for consistency with prudential data

Basel 2 with Pillar III disclosures and IFRS 9

- » Principles are consistent with IFRS objectives: clarity, comprehensiveness, usefulness consistency, comparability
- » Some topics are the same:
  - » Information about risk exposures and mitigation
    - » Credit risk
    - » Market risk
- » Operational risk is not included in IFRS
- » Basel II pillar 3 requires certain formats for presenting quantitative information when IFRS is more flexible
- » Both IFRS and Basel II required quantitative and qualitative information

Importance to look at the two sources of information when reviewing the financial instrument portfolios and risks associated

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Thank you