

IFRS News

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IFRS 7 – Frequently asked questions • October 2006

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IFRS 7 – Frequently asked questions

IFRS 7 deals with financial instrument disclosures and replaces the requirements in IAS 30 (disclosure requirements for banks and similar financial institutions) and in IAS 32. It also amends the existing risk disclosure requirements for insurance contracts in IFRS 4. A concurrent amendment to IAS 1 requires additional disclosures about the objectives, policies and processes used by the entity to manage its capital.

IFRS 7 applies to financial and non-financial institutions. The extent of disclosure required depends on the extent of the entity's use of financial instruments and its exposure to risk. It applies to recognised and unrecognised financial instruments. An example of an unrecognised financial instrument is a loan commitment.

IFRS 7 is divided into two distinct sections. The first covers disclosures about the numbers in the balance sheet and the income statement. The second deals with risk disclosures. It is the second section where the new standard takes a very different approach. The risk disclosures arising from financial instruments are given 'through the eyes of management'. The information that is provided to key management personnel is the basis for the information that is disclosed. Certain disclosures should be given to the extent they are not part of the 'through the eyes of management' disclosures.

The new disclosure requirements are applicable for annual periods beginning on or after 1 January 2007; earlier application is encouraged.

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Scope

Question 1

Are operating leases within the scope of IFRS 7?

Answer 1

No, except for individual payments that are currently due and payable. Other payments under operating leases are not regarded as a financial instruments (IAS 32.AG9).

Question 2

Are disclosures about operational risk required by IFRS 7?

Answer 2

No. Operational risk disclosures are not within the scope of IFRS 7.

Classes of financial instrument

Question 3

IFRS 7 requires certain disclosures to be given by class of financial instrument – for example, the reconciliation of an allowance account (IFRS 7.16). IFRS 7 does not provide a prescriptive list of classes of financial instruments. It states that a class should contain financial instruments of the same nature and characteristics and that the classes should be reconciled to the line items presented in the balance sheet (IFRS 7.6).

What considerations should an entity apply in identifying different classes of financial instruments since a prescriptive list of classes is not provided? For example, should a bank disclose 'loans and advances' as a single class, or should it be split further into separate classes?

Answer 3

A 'class' of financial instruments is not the same as a 'category' of financial instruments. Categories are defined in IAS 39 as financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables, available-for-sale financial assets, financial liabilities at fair value through profit or loss and financial liabilities measured at amortised cost.

Classes are expected to be determined at a lower level than the measurement categories in IAS 39 and reconciled back to the balance sheet, as required by IFRS 7.6. However, the level of detail for a class should be determined on an entity-specific basis.

In the case of banks, the category 'loans and advances' is expected to comprise more than one class unless the loans have similar characteristics. For example, it may be appropriate to provide separate classes by:

- types of customers – for example, commercial loans and loans to individuals; or
- types of loans – for example, mortgages, credit cards, unsecured loans and overdrafts.

In some cases, 'loans to clients' can be one class if all the loans have similar characteristics (for example, a saving banks providing only one type of loan to individuals).

Fair value disclosures

Question 4

Should interest income, interest expense and dividend income on financial instruments at fair value through profit or loss be reported as part of net gains or net losses on these financial instruments or disclosed separately as part of interest income, interest expense or dividend income?

Answer 4

IFRS 7 Appendix B5(e) allows an accounting policy choice between these two treatments. The chosen policy should be consistently applied and disclosed.

It is possible to adopt one treatment for interest income and interest expense and a different treatment for dividend income, as no such prohibition exists in IFRS 7. However, the reporting of interest income should be consistent with that of interest expense.

IAS 18.35(b)(v) requires entities to disclose the amount of dividend income, if significant. Therefore, if dividend income is reported as part of net gains or net losses on financial instruments at fair value through profit or loss (FVTPL), the amount of dividend income on financial assets at FVPTL should be disclosed in the notes.

If the entity reports interest income and interest expense on financial instruments at FVTPL within interest income and interest expense, it should use the effective interest method in accordance with IAS 18.30(a) and IAS 39.9.

Question 5

Should a bank's funding costs associated with trading activities be presented as part of interest expense or disclosed in the trading line?

Funding costs relating to trading assets are generally determined by applying the bank's average monthly/yearly refinancing interest rate to the average trading assets in the balance sheet. Would the answer be different if the bank could directly relate funding costs to specific trading assets (ie, as opposed to an average allocation basis)?

Answer 5

Funding costs associated with trading activities should be presented as part of interest expense and should not be included in the trading line. A bank presents an income statement that groups income and expenses by nature. Funding costs, by nature, represent interest expense not trading activities. In addition, IAS 39.AG 15 states that the fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

The answer remains the same regardless of whether the funding costs are allocated on an average basis or on a more specific one-to-one basis (which in practice is difficult to do), as it does not represent a trading result.

Question 6

An entity has issued a convertible bond that under IAS 32 is accounted for as a compound instrument. The liability component is measured at amortised cost. According to IFRS 7.25, the entity is required to disclose the fair value of the financial instrument in a way that permits it to be compared with its carrying amount. Is the fair value disclosure required:

- (a) only for the liability component?
- (b) separately for the liability and the equity components? or
- (c) for the convertible bond in its entirety?

Answer 6

Option (a) is correct. IFRS 7.25 requires fair value disclosures only for financial assets and liabilities. As the equity component does not meet the definition of a financial asset or financial liability, the fair value of only the liability component has to be disclosed.

Defaults and breaches

Question 7

Before the balance sheet date, an entity has breached the terms of a loan agreement giving the counterparty the right to demand accelerated repayment. The counterparty waives its right to demand accelerated repayment after the balance sheet date but before the signing of the financial statements. Does the entity have to disclose the breach of covenant?

Answer 7

Yes. The breach is regarded as remedied only if the waiver is *legally* enforceable on or before the balance sheet date in accordance with IFRS 7.19 and IAS 1.65.

Hedge accounting disclosures

Question 8

For fair value hedges, IFRS 7.24(a) requires the disclosure of gains or losses on the hedging instrument and on the hedged item attributable to the hedged risk. Management assesses hedge effectiveness on a cumulative basis. Should the disclosure required by IFRS 7.24(a) be made on a cumulative basis (since inception of the hedge designation)?

Answer 8

No. Management should disclose gains and losses on the hedging instrument and on the hedged item for the current reporting period only.

Risk disclosures

Question 9

In the process of adopting IFRS 7, management changes its objectives, policies and processes for managing financial risk during the first comparative period (for example, during 2006 for a calendar year-end entity adopting IFRS 7 for accounting periods beginning on or after 1 January 2007). In its 2006 financial statements, management disclosed the changes in its IAS 32 disclosures.

IFRS 7.33(c) requires the disclosure of changes in objectives, policies and processes for managing financial risk from the previous period.

Is the entity required to disclose the changes in how it manages financial risk in its 2007 financial statements?

Answer 9

No. The changes in objectives, policies and processes for managing financial risk were already disclosed in the 2006 financial statements under IAS 32, so no further disclosure needs to be made in 2007. However, if such disclosures are not made in the 2006 financial statements and the changes are significant, they should be disclosed in the 2007 financial statements in accordance with IFRS 7.

Question 10

An entity invests in a foreign currency bond maturing in one year and simultaneously enters into a foreign exchange forward contract with a corresponding maturity to offset the foreign currency risk. IFRS 7.34(b) requires specific risk disclosures for material risks. Is the materiality of the foreign currency risk on the bond assessed with or without the foreign exchange forward contract?

Answer 10

The materiality of the foreign currency risk on the bond is assessed without the foreign exchange forward contract.

The bond and the foreign exchange forward are dissimilar items (IAS 1.29). The materiality assessment of the foreign currency risk is therefore performed without considering the foreign exchange forward contract.

If it is established that the foreign currency risk is material, the disclosure required in the sensitivity analysis (IFRS 7.40 and 7.41) is based on the net foreign exchange exposure. That is, after offsetting the foreign currency bond against the foreign exchange forward contract.

The same approach would apply for the assessment of credit risk, liquidity risk and other market risk.

Credit risk

Question 11

IFRS 7.37(a) requires entities to disclose an analysis of the age of financial assets that are past due at the reporting date but not impaired. What does 'past due' mean?

Answer 11

As defined in IFRS 7 Appendix A, a financial asset is past due when a counterparty has failed to make a payment when contractually due. Past due therefore includes all financial assets that are one or more days overdue. Although IFRS 7.34(a) requires risk disclosures that are based on the information provided to key management personnel, there are also some minimum disclosure requirements defined by IFRS 7 (IFRS 7.36-42) that must always be disclosed.

Question 12

IFRS 7.37(a) requires an analysis of the age of financial assets that are past due as at the reporting date but not impaired. What amount should be disclosed to satisfy this requirement? Should it be:

- (a) only the amount past due (ie, the instalment not paid when contractually due);
- (b) the whole balance that relates to the amount past due; or
- (c) the whole balance that relates to the amount past due, including any other balances with the same debtor?

Answer 12

Option (b) is correct. Management should disclose the whole balance that relates to the amount past due.

IFRS 7 BC55(a) explains that the purpose of the disclosure required in IFRS 7.37(a) is to provide users of the financial statements with information about those financial assets that are more likely to become impaired and to help users to estimate the level of future impairment losses. The whole balance that relates to the amount past due should therefore be disclosed, as this is the amount that would be disclosed as the amount of the impaired financial assets if an impairment crystallises.

Other associated balances to the same debtor should not be disclosed as past due but not impaired, as the debtor has not failed to make a payment on these when contractually due.

Question 13

An entity holds equity investments in other entities. Its management asserts that the IFRS 7 credit risk disclosures (IFRS 7.36-38) are not relevant.

Do the credit risk disclosures required by IFRS 7.36-38 apply to an entity's holdings of equity investments?

Answer 13

No, except for IFRS 7.37(b) (see Question 14). The definition of equity in IAS 32 requires the issuer to have no obligation to pay cash or transfer other assets. It follows that such equity

investments are subject to price risk, not credit risk. Most of the IFRS 7 credit risk disclosures are not therefore relevant to investments in equity instruments.

However, IFRS 7.37(b) requires entities to disclose an analysis of financial assets that are impaired. This disclosure is relevant and should be given for impaired equity investments classified as available for sale.

Question 14

An equity investment categorised as available for sale was assessed as being impaired in 20x1, and the related loss was included in the income statement as an impairment loss. As the asset is impaired it is included in the disclosures of impaired financial assets (IFRS 7.37 (b)) in the year of impairment. Should there be a disclosure in the subsequent year as well?

Answer 14

As long as the fair value of the financial asset is below its historical cost, the financial asset is considered as 'impaired' and should therefore be included in the disclosure of impaired financial assets. When the fair value returns to above its historical cost, the asset should be excluded from the disclosure (this answer is also applicable to a debt instrument classified as AFS).

Question 15

IFRS 7.36(d) requires entities to disclose the carrying amount of renegotiated financial assets that would otherwise be past due or impaired.

Should the disclosure be given only in the year when the renegotiation took place or in all subsequent years until the financial assets is disposed of?

Answer 15

This disclosure should be given only in the year when the renegotiation took place. In subsequent years, the asset is considered based on the new (renegotiated) terms; it would be disclosed in accordance with IFRS 7.36(d) only if renegotiated again.

Question 16

IFRS 7 defines credit risk as 'The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. If an entity issues a financial guarantee, the financial loss will not result from a default by the other party of the contract (the holder), but from a default by the third party (the debtor). Does this mean that the credit risk of financial guarantees can be excluded from the disclosure of the maximum exposure to credit risk?

Answer 16

No, the credit risk of financial guarantees should be included in the disclosures, as IFRS 7 Appendix B10(c) clarifies that the definition of credit risk includes that arising from financial guarantees.

Liquidity risk – maturity analysis

Question 17

IFRS 7.39(a) requires the disclosure of a maturity analysis for financial liabilities that shows the remaining contractual maturities.

Should the following financial instruments be shown in one maturity bucket, or split across the maturity buckets in which the cash flows occur?

- (a) a derivative which has multiple cash flows;
- (b) a loan which has annual contractual interest payments; and
- (c) a loan which has annual contractual interest and principal repayments?

Answer 17

All the financial instruments should be split across the maturity buckets in which the cash flows occur. The requirement is to disclose each of the contractual payments in the period when they are due (including principal and interest payments). The objective of this particular disclosure is to show the liquidity risk of the entity.

Question 18

IFRS 7.39 requires entities to disclose (a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and (b) a description of how it manages the liquidity risk inherent in (a).

Does this mean that a maturity analysis for financial assets based on remaining contractual maturities, previously required by IAS 30.30, is no longer required?

Answer 18

Yes, IFRS 7 requires a maturity analysis based on the remaining contractual maturity only for financial liabilities. Management can choose to disclose the maturity analysis showing remaining contractual maturity for financial assets as one of the disclosures to comply with the requirement in IFRS 7.39(b). However, it is not obligatory.

In practice, an entity should disclose a maturity analysis of financial assets and financial liabilities showing expected maturity if this is the information provided to key management personnel to manage the business (IFRS 7.34(a)). However, a maturity analysis based on the remaining contractual maturity for financial liabilities should be disclosed.

Question 19

IFRS 7 Appendix B14 requires the amounts in the maturity analysis to be undiscounted amounts.

Is there a requirement to reconcile the undiscounted amounts in the maturity analysis to the discounted amount in the balance sheet?

Answer 19

No. The only reconciliation requirements relate to the disclosures by classes of financial instruments (IFRS 7.6).

Question 20

Should derivatives with a positive fair value be included in the maturity analysis?

Answer 20

Only derivatives that have a negative fair value should be included in the maturity analysis with the exception of gross-settled forward contracts (see question 21).

Question 21

What cash flows from foreign exchange forward contract and other gross-settled derivatives should be included in the maturity analysis?

Answer 21

IFRS 7 Appendix B14 requires prices specified in forward agreements to purchase financial assets for cash to be included in the maturity analysis. This means that the pay-leg of all gross-settled foreign exchange forward contracts should be included, whether or not the fair value of the derivative is negative. A foreign exchange forward contract is a contract to receive a specified amount of cash either in a foreign or local currency; cash is a financial asset.

While IFRS 7 only requires the gross cash outflows to be included in the maturity analysis, a separate disclosure of the inflows in conjunction with the outflows would make the information more meaningful.

Question 22

Amounts disclosed in the maturity analysis should be contractual undiscounted cash flows (IFRS 7 Appendix B14). What rate should be used to determine the amounts to be disclosed for floating rate financial instruments and instruments denominated in a foreign currency?

Should it be the current rate or the forward rate?

Answer 22

IFRS 7 Appendix B16 states that amounts not yet fixed at the reporting date are determined by reference to the conditions existing at the reporting date. Best practice is for future interest payments to be determined by using forward interest rates, and the payments in a foreign currency to be translated into the functional currency using foreign exchange forward rates.

This approach is conceptually preferable; however, using the current rate is also acceptable. The chosen approach should be applied consistently.

Market risk – sensitivity analysis

Question 23

Are entities required to provide sensitivity analysis on a 'worse case scenario' basis?

Answer 23

No, IFRS 7.40(a) requires a sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. A reasonably possible change is judged relative to the economic environments in which the entity operates; it does not include remote or 'worst case' scenarios or a 'stress test'. Entities are not required to disclose the effect for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient (IFRS 7 Appendix B18-19).

Question 24

IFRS 7 requires the disclosure of a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date (IFRS 7.409(a)). Alternatively, management can prepare a sensitivity analysis that reflects *interdependencies between risk variables* if that is how it manages its financial risks (IFRS 7.41).

An entity uses a value-at-risk (VaR) methodology that reflects interdependencies between risk types for its trading book but manages its non-trading book using a methodology that reflects each type of market risk. Can the entity:

- disclose its VaR figures for the trading book and a sensitivity analysis for each type of market risk for its non-trading book?
- apply the sensitivity analysis as outlined in IFRS 7.40(a) to both its trading and non-trading books and ignore the VaR figures?
- apply the VaR figures to both its trading and non-trading books?

Answer 24

- Yes. An entity may provide different types of sensitivity analysis for different classes of financial instruments (IFRS 7 Appendix B21).
- Yes. Applying the sensitivity analysis outlined in IFRS 7.40(a) for the whole of the business is permitted.
- No. A precondition for disclosing VaR figures is that the company uses VaR in managing the financial risks (IFRS 7.41).

Question 25

Translation exposure arises from the consolidation of the financial statements of overseas net investments (for example, subsidiaries whose functional currency is different from the group's presentation currency). Foreign currency effects of translation exposures are shown in the group's consolidated equity as cumulative translation adjustments. Are such foreign currency translation adjustments in equity included in the sensitivity analysis for foreign currency risks required by IFRS 7.40?

Answer 25

No. IFRS 7 Appendix B23 defines that foreign exchange risk can only arise on financial instruments that are denominated in a

currency other than the functional currency in which they are measured. Translation exposures arise from financial and non-financial items held by an entity with a functional currency different from the presentation currency of the group. Translation-related risks are not therefore taken into consideration for the purpose of the sensitivity analysis for foreign currency risks.

Question 26

The foreign exchange revaluation effects of a foreign currency inter-company loan that is part of the net investment in a foreign operation ('quasi-equity' loans) are deferred in equity until disposal (or partial disposal) of the foreign operation.

Are these foreign currency revaluation effects included in the sensitivity analysis for foreign currency risks?

Answer 26

No. Quasi-equity loans should not be part of the analysis. Foreign exchange gains and losses on quasi-equity loans have an effect on equity as they are part of the cumulative translation adjustments, and therefore represent a translation risk rather than a transaction risk.

Question 27

Should foreign currency inter-company accounts receivables and accounts payables be included in the sensitivity analysis for foreign currency risks although such balances are eliminated for the presentation of the consolidated financial statements?

Answer 27

Yes. Even though the intra-group receivables and payables are eliminated in the balance sheet, the effect on profit or loss of their revaluation under IAS 21 is not fully eliminated.

Interim reporting

Question 28

An entity has early adopted IFRS 7 from 1 January 2006. Management is preparing its interim financial report for the period ended 30 June 2006. Should it apply IFRS 7 in the interim financial statements for the period ended 30 June 2006?

Answer 28

If the entity's interim financial report includes only condensed financial statements and selected explanatory notes, it is not required to apply the disclosure requirements in IFRS 7 unless there are some events and transactions related to financial instruments that are material to an understanding of the current interim period (IAS 34.16 and IAS 34.18). However, management should disclose that IFRS 7 was adopted early and that full disclosures as required by IFRS 7 will be disclosed in the year-end financial statements.

If the entity prepares a complete set of interim financial statements, IFRS 7 should be applied in this set of financial statements, including full comparative information.