IFRS News

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IFRS 7 – Frequently asked questions • December 2007

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This supplement provides FAQs relating to various areas of IFRS 7. These follow on from the first set of IFRS 7 FAQs published in the October 2006 supplement to *IFRS News*.

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Scope

Question 1

Are accruals included in the scope of IFRS 7?

Answer 1

It depends. Some accruals represent a right to receive cash or an obligation to deliver cash and are included in the scope of IFRS 7. An example is an accrual for services obtained but for which an invoice has not been received.

A prepaid expense (for example, a prepaid rent or prepaid insurance premium) or an advance payment received is not a financial instrument and is excluded from the scope of IFRS 7.

Question 2

Are provisions included in the scope of IFRS 7?

Answer 2

No. Provisions that meet the definition of IAS 37.10 ('liability of uncertain timing and amount') are scoped out of IFRS 7 [IAS 37.2 and IFRS 7.3-4 in combination with IAS 39.2(j)]. Financial guarantee contracts that are measured in accordance with IAS 37 are nevertheless financial instruments that fall within the scope of IFRS 7.

Fair value disclosures

Question 3

IFRS 7.9(c) states that:

'If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss ("FVTPL"), it shall disclose:

(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
   (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
   (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.'

Would we expect this to apply to all assets that are measured at FVTPL, or is it limited to loans and receivables that are designated at FVTPL? For example, would this paragraph apply to listed bonds?

Answer 3

Only loans and receivables that were designated at FVTPL are included in this disclosure required by IFRS 7.9(c).

Listed bonds are not classified as loans and receivables in accordance with IAS 39.9, as they are quoted. They do not therefore need to be disclosed under IFRS 7.9(c) above.

Defaults and breaches

Question 4

An entity systematically pays its short-term accounts payable (contractually due in 60 days) after the contractually due date (to finance its business). Does the entity include these trade payables in the disclosure required of defaults and breaches on loans payable required by IFRS 7.18-19?

Answer 4

No. Based on the definition of loans payable in Appendix A, short-term payables are not loans payable and are therefore excluded from the disclosures of defaults and breaches required by IFRS 7.18-19.

Hedge accounting disclosures

Question 5

IFRS 7 applies to financial assets and financial liabilities that are within the scope of IAS 39 [IFRS 7.4].

When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability in terms of IAS 39 [IAS 39.93].

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. Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities [IFRS 7, Appendix A].

Does a firm commitment asset or liability expose the entity to credit and/or liquidity risk?

Answer 5

No. A firm commitment to acquire a non-financial asset or liability does not meet the definition of a financial asset or financial liability and is therefore outside the scope of IFRS 7. The asset or liability resulting from the application of hedge accounting simply measures the cumulative exposure of the entity to the hedged risk. However, a firm commitment to acquire a financial asset or liability is itself a financial instrument and falls within the scope of IFRS 7.

Risk disclosures

Question 6

How does an entity with two distinct operations (for example, a retail division and a bank division) present the minimum risk disclosures required by IFRS 7.34(b) and IFRS 7.36-42?

Answer 6

An entity with two distinct divisions is permitted to provide the minimum disclosures on a consolidated basis for the bank and the retail business. IFRS 7 disclosures are normally provided on a consolidated basis in accordance with IAS 27.22, unless there is a specific exception (such as for those disclosures that are based on management's reporting).

Alternatively the entity can choose to provide the minimum disclosures separately for the bank and the retail business to reflect the way management monitors the financial risks. However, if there were material transactions between the businesses, separate disclosure may be misleading.

Question 7

Does an entity restate the comparative risk disclosures for changes in volatility? For example, the reasonably possible change in an exchange rate changes from 5% in the prior year to 8% in the current year?

Answer 7

No. The prior-year disclosures are not restated if volatility (and therefore the range for a reasonable change) increases or decreases between two balance sheet dates.

Question 8

Entity Y is producing seeds for the agricultural industry. The main season for planting the seed is spring. 75% of Y's markets are in the northern hemisphere; 25% are in the southern hemisphere. Entity Y's account receivables are approximately £400 million in June and £100 million in December. Entity Y has a December year end. Does Y have to disclose additional information about its exposure to credit risk on the receivables that is representative of its exposure to risk during the year (IFRS 7.35)?

Answer 8

Yes. The December year-end exposure to credit risk is unrepresentative of the entity's exposure during the period. Entity Y should provide further information that is representative, such as a description (with amounts) of how the exposures vary during the year, or the average (or highest) exposure to credit risk during the year.

Credit risk

Question 9

IFRS 7.37(b) states that disclosure includes an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired.

Consider a situation where an entity has £300m of receivables where this amount is categorised into:

(i) £100m of the receivables that have been assessed individually for impairment and based on the conditions stated in IAS 39.58-61 are concluded tobe impaired;

(ii) £100m of a collection of insignificant receivables that are individually concluded to be impaired on the basis of the IAS 39 but the impairment calculation is carried out on the £100m amount for efficiency purposes; and

(iii) £100m of a portfolio of assets for which there is observable data indicating that there is a measurable decrease in the estimated future cash flows from that group of financial assets, although the decrease cannot be identified with individual financial assets [IAS 39.59(f)].

Of these three categories, which require disclosure under IFRS 7.37(b)?

Answer 9

Both categories (i) and (ii) require disclosure under IFRS 7.37(b); in these categories the assets are individually assessed for impairment.

The disclosure is not required for category (iii); in this category the assets are assessed on a portfolio basis rather than an individual basis. However, actual impairment loss on the portfolio of assets is disclosed for income statement purposes under IFRS 7.20(e): 'An entity shall disclose the amount of any impairment loss for each class of financial assets either on the face of the income statement or in the notes'.

Liquidity risk – maturity analysis

Question 10

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

Answer 10

IFRS 7 B14 requires prices specified in forward agreements to purchase financial assets for cash to be included in the maturity analysis. This means that 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, and cash is a financial asset.

While the standard 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 11

If gross cash flows are exchanged under a derivative contract, does IFRS 7 require disclosure of the gross cash flows, even if the exchange occurs simultaneously?

Answer 11

Yes. IFRS 7 B14(d) is clear that contractual amounts exchanged in a derivative financial instrument (for example, a currency swap) are disclosed on a gross basis if gross cash flows are exchanged. This is the case even if the cash flows are exchanged simultaneously.

Question 12

Are financial guarantees (in the scope of IAS 39 and therefore also in the scope of IFRS 7) included in the maturity analysis? If so, in which time band is the financial guarantee included in the maturity analysis?

Answer 12

No. At the balance sheet date, the counterparty does not have a right to demand cash; there is therefore no time bucket to which the cash flow can be attributed.

This is because IFRS 7 B12 states that when a counterparty has a choice of when an amount is paid, the liability is included on the basis of the earliest period in which the entity can be required to pay. However, at the balance sheet date, the counterparty does not have the right to demand cash, as the default has not occurred.

IFRS 7 B16 states that when the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at balance sheet date. Because the counterparty has no right to demand cash during the pre-default period, IFRS 7 B16 is not relevant.

Question 13

How is a written put option treated in the maturity analysis?

Answer 13

It depends on whether the option is settled net or gross and whether the option is in our out of the money at the balance sheet date.

If the option is out of the money and net settled, no liability is required to be disclosed in the maturity table, because there is no obligation to make a payment based on the conditions existing at the balance sheet date (IFRS 7 B16).

For gross settled derivatives where the counterparty can force the issuer to make a payment, the pay leg is disclosed in the

liquidity table in the earliest time bucket irrespective of whether the instrument is in or out of the money.

An American-style option is disclosed in the earliest time band; a European-style option is disclosed depending on the exercise date.

Question 14
A company monitors and manages liquidity risk using cash flow forecasts, including forecasts of revenue, operating cash outflows and financing items. Does IFRS 7 require the entity to disclose those cash flow forecasts?

Answer 14
No. Although IFRS 7.33, 7.34 and 7.39 require an entity to provide both qualitative and quantitative information about its exposure to a particular risk, the standard only requires qualitative information about how it manages that risk.

The information contained in a cash flow forecast relating to cash inflows from revenues, sales of assets and new financings, and about cash outflows from operations and sources other than financial liabilities represents information that management uses to manage the liquidity risk as defined in IFRS 7 (the cash outflows associated with financial liabilities). Accordingly, this will be disclosed by way of qualitative information. This might take the form of a disclosure that regular cash flow forecasts are prepared and reviewed by management, together with the other factors management used to manage liquidity risk (which might include some or all of the factors listed in IG31).

Question 15
Bank A gives entity B Ltd a credit facility of £3m at the rate of 7% on 1 January. B Ltd has to repay any amounts drawn under the facility in five years time and pays quarterly interest. On 31 December, B Ltd has drawn down £1m.

What amounts should be included in the maturity analysis in respect of the above facility by:
(i) Bank A; and
(ii) Entity B Ltd?

Answer 15
(i) Bank A should include the undrawn amount (£2m) of the credit facility in the earliest period in which the B Ltd is be able to draw it [IFRS 7 B.13]. The bank could choose to show the liquidity risks arising from off-balance sheet items in a separate table.

IFRS 7 B16 is not relevant, because the amount that the counterparty can require to be paid in cash is fixed.

(ii) B Ltd should include the drawn amount of £1m in a time band of five years reflect when repayment is contractually due. B should also disclose the interest payments on the debt over the same five-year period. The undrawn amount of £2m does not represent a future cash outflow and is therefore not included in the maturity analysis.

Additional details of the undrawn facilities and any restrictions on them are recommended disclosure under IAS 7.50(a).

Market risk – sensitivity analysis

Question 16
An entity uses highly effective cash flow hedges to hedge the foreign currency risk of future sales in a foreign currency. How does the entity reflect the effect of the hedge on profit or loss and equity in the sensitivity analysis (IFRS 7.40(a))?
Answer 16
The fair value movement related to the effective part of the hedging instrument is included in equity. Ineffectiveness is reflected in profit or loss.

Movements on the foreign exchange risk exposure on the future sales are not included in the sensitivity analysis, as they were not recognised financial assets or financial liabilities at the balance sheet date.

Question 17
An entity is required to show in a sensitivity analysis the impact of a reasonably possible shift in market risks on profit or loss and equity. Does an entity that has AFS equity investments take into consideration its impairment policy to distinguish between impacts on equity (if a reasonably possible decrease in share prices results in an amount below the impairment threshold) and impacts on profit or loss (if a reasonably possible decrease in share prices results in an amount above the impairment threshold)?

Answer 17
Yes. In cases where the fair value of a non-monetary AFS instrument is close to the impairment threshold, the entity distinguishes between profit or loss and equity effects, taking into consideration its impairment policy.

In cases where a non-monetary AFS financial asset is already impaired, the downwards shift is shown as affecting profit or loss; the upwards shift is shown affecting equity.

Question 18
An entity uses a value-at-risk (VaR) model for managing its currency exposures (interdependencies are reflected). However, outstanding inter-company foreign currency receivables and payables at year-end are not considered in the VaR model. Does the entity prepare additional disclosures for the currency risk on inter-company transactions?

Answer 18

Yes, the entity prepares additional sensitivity disclosures for the outstanding inter-company foreign currency receivables and payables, as changes in exchange rates will have an effect on profit or loss arising from these balances.

Question 19

IFRS 7.40 requires an entity to disclose the effect on net income and equity of reasonably possible changes in market prices.

Certain entities are exposed to changes in their own stock price – for example, entities that have issued warrants with a foreign currency exercise price that are classified as derivative liabilities or entities that have issued convertible debt that fails the fixed-to-fixed requirement in IAS 32. In other cases, entities may have issued share-based compensation awards that are classified as liabilities.

Where an entity's net income is affected by changes in its own share price, does it disclose the effect on net income of reasonably possible changes in its share price on:

a) financial instruments that it issued which are within the scope of IAS 39?
b) share-based payment awards with the scope of IFRS 2?

Answer 19

a) Yes, an entity discloses information about the effect of reasonably possible changes in its share price on its net income, because instruments within the scope of IAS 39 are generally within the scope of IFRS 7, and because changes in the market value of the entity's own stock meet the definition of an 'other price risk'. The effect on net income of reasonably possible changes in an entity's own share price (if any) is therefore disclosed. The same might be true for financial instruments other than shares – for example, derivatives on own shares or an entity's debt instrument, if they are classified as at FVTPL.
b) No, instruments within the scope of IFRS 2 (and not within the scope of IAS 39) are scoped out by IFRS 7.3(e).

Question 20

An entity uses for own risk management purposes a 10-day VaR. Management believes that this 10-day VAR satisfies the requirements of IFRS 7.41 and does not prepare an additional disclosure based on IFRS 7.40. Do you agree with management?

Answer 20

Yes. IFRS 7 B20 is clear that the method used by management does not need to reflect the total income statement impact ('this applies even if such a methodology measures only the potential loss and does not measure the potential gain'). In addition, BC61 explains that the Board decided not to require disclosure on the effects on profit or loss and equity if an alternative disclosure of sensitivity is made.

Other disclosure issues

Question 21

A subsidiary prepares stand-alone IFRS financial statements, but the financial risk management is carried out centrally by the parent. The parent prepares a VaR analysis for the entire group. Does the subsidiary still need to prepare the market risk sensitivity analysis as required by IFRS 7.40?

Answer 21

Yes. The subsidiary should comply with the minimum disclosure requirements in its stand-alone financial statements.