

IFRS 7 *Financial Instruments: Disclosures* – Impending changes effective for 2011 and 2012

What you need to know

- ▶ Some of the changes to disclosures are effective as early as periods beginning on or after 1 July 2011
- ▶ The requirement to disclose the financial effect of collateral held is likely to be a systems challenge or a labour-intensive exercise for many entities
- ▶ 'Continuing involvement' has been defined differently for disclosures of transfers of assets
- ▶ Judgment will be needed to determine the extent of some of the new disclosures

Background

IFRS 7 *Financial Instruments: Disclosures* (IFRS 7) is a standard that is continually evolving in response to demands from stakeholders for more robust and high quality disclosures in respect of financial instruments. During 2010, several changes were made to IFRS 7 that are set to take effect in 2011 and 2012.

What are the changes?

The first set of changes was issued by the International Accounting Standards Board (IASB) as Annual Improvements. The Annual Improvements process provides a mechanism for making necessary but non-urgent amendments to IFRS. The IFRS 7 Improvements (the Improvements) affect the existing credit risk disclosures. We highlighted this in our *Supplement to IFRS outlook Issue 71: Improvements to IFRSs 2010*.¹ The Improvements are effective for financial years commencing on or after 1 January 2011.

The second set of changes took the form of amendments to IFRS 7 (the Amendments) that were issued in October 2010 to improve the disclosure requirements relating to the transfer of financial assets. The IASB issued these enhanced disclosure requirements so that users of financial statements will, in future, have a better understanding of transactions involving the transfer of financial assets (e.g., securitisations), including the possible effects of any risks that may remain with the transferor.

The detailed disclosure requirements were highlighted in our publication, *Supplement to IFRS outlook Issue 85: New disclosures for derecognition of financial instruments*.² The effective date for the Amendments is annual periods beginning on or after 1 July 2011 and comparative disclosures are not required for any period beginning before that date. Earlier application is permitted subject to disclosure of that fact.

In this supplement, we take a look at some of the practical considerations that may arise when implementing the Improvements and Amendments in 2011 and 2012, respectively.

¹ Available at www.ey.com/ifrs.

² Available at www.ey.com/ifrs.

The Improvements to credit risk disclosures

The Improvements affect the existing quantitative credit risk disclosures. They:

- ▶ Clarify that further disclosure of the amount that represents the maximum exposure to credit risk is needed only for financial assets whose carrying amount does not already reflect the maximum exposure to credit risk
- ▶ Require, for all financial assets, disclosure of the financial effect of collateral held as security and other credit enhancements (i.e., a quantification of the extent to which collateral mitigates credit risk)
- ▶ Remove the previous requirement to disclose collateral held as security, other credit enhancements and an estimate of their fair value, for financial assets that are past due but not impaired and those that are individually determined to be impaired
- ▶ Remove the requirement to specifically disclose financial assets, the terms of which have been renegotiated
- ▶ Clarify that the disclosure required for financial or non-financial assets obtained during the period, by taking possession of collateral or calling on other credit enhancements, is only applicable to assets still held at the reporting date

The 'financial effect' of collateral held

Some constituents are unclear whether the IASB intended 'the financial effect' to be a risk measure or a profit or loss measure (i.e., in the latter case, the effect of collateral on the calculation of impairment losses). Whilst it is not explicit in the Improvements, we believe that the IASB intended the financial effect to be a risk measure that shows the impact of collateral and other credit enhancements in reducing the maximum exposure to credit risk. This can be inferred from the Basis for Conclusions to the Improvements which states that the IASB was concerned that

the previous requirement to disclose the fair value of collateral was potentially misleading. This concern arose because of the scenario in which certain assets within a particular class may be over-collateralised while other assets could be under-collateralised. Hence, the effect of over-collateralisation will offset the effect of under-collateralisation, resulting in the disclosure of an amount that does not actually represent the maximum exposure to credit risk.

Practical implications

These Improvements are intended to simplify the disclosures and reduce the amount of time and effort needed to prepare an entity's financial statements. Whilst this is true for most of the Improvements, the requirement to disclose the financial effect of collateral held as security is likely to be either a systems challenge or a labour-intensive exercise for many entities.

Entities will need to obtain collateral values for all financial assets and eliminate the effect of over-collateralisation for individual assets. It is unlikely that most entities will have up-to-date information on collateral values readily available. They may need to undertake significant upgrades to their IT systems to collect the data. The requirement may also give rise to additional external costs such as valuation fees.

For many classes of assets, it may be that the entity is confident that the fair value of collateral exceeds the recorded value of each asset, in which case, the disclosure will just be the asset values. This requirement will be more onerous for those classes of assets where some assets are over-collateralised while, in other cases, the fair value of the collateral is lower than the carrying amount of the asset. Again, making the comparison, and eliminating any excess collateral from the disclosures, will require systems amendments or else considerable labour commitment.

Collateral repossessed in the period

In respect of the final requirement listed above, the Improvements clarify that disclosure is only required for collateral repossessed during the period and still held at the reporting date. Hence, collateral that is repossessed during the period and disposed of before the end of the reporting period will not require disclosure. While disclosure is only required for collateral repossessed during the current period, it would be useful for entities to also disclose the collateral repossessed during prior periods and still held at the reporting date. However, this is not stipulated in the Improvements.

The Amendments on disclosures of transfers of financial assets

For those entities with a December financial year end, the Amendments will be mandatory for financial years ending 31 December 2012. However, some preparers have already started planning to ensure that they have sufficient time to accumulate the required data and information (refer to the Appendix for a list of detailed disclosures). While the Amendments require disclosures for transfers of financial assets that are derecognised in their entirety as well as those that are not, this Supplement focuses on the former.

Disclosures are required for financial assets that are derecognised in their entirety and where the entity has a 'continuing involvement' in them (e.g., through options, guarantees, etc.).

Continuing involvement

'Continuing involvement' as defined for disclosure purposes (in the Amendments) is different from that applied for accounting purposes in IAS 39 *Financial Instruments: Recognition and Measurement* (now carried forward to IFRS 9 *Financial Instruments*).

The Amendments define 'continuing involvement' to be where the entity:

- ▶ Retains any of the contractual rights or obligations inherent in a transferred financial asset

Or

- ▶ Obtains any new contractual rights or obligations relating to a transferred financial asset.

Continuing involvement in IAS 39/IFRS 9 applies in circumstances where an entity neither transfers nor retains substantially all of the risks and rewards of the transferred asset, but retains control of the transferred asset. In these circumstances, the transferred asset is not derecognised in its entirety. In contrast, the new disclosures are required whenever the transferred asset is derecognised in its entirety, but where the transferor retains any form of rights or obligations relating to such an asset. This distinction may not have been fully appreciated by all preparers when the Amendments were originally released in October 2010.

Retrospective application

A second issue to consider, given that the Amendments require retrospective application, is how far back entities will need to analyse transactions to determine whether there is any continuing involvement from past derecognition transactions. These would require disclosure under the Amendments.

One school of thought has been that the Amendments only apply to assets that were derecognised on or after 1 January 2004. This is the date from which the IAS 39 derecognition requirements were applied on a prospective basis. Furthermore, for IFRS adopters, IFRS 1 *First Time Adoption of International Financial Reporting Standards* (IFRS 1) only required the IAS 39 derecognition requirements to be applied prospectively to derecognition transactions entered into on or after 1 January 2004.³

An alternative view is that the disclosures will be required for any derecognition transaction in the past, potentially even from decades ago, if there is still a continuing involvement. This view is based on the IASB's statement that it specifically added these disclosure requirements to address concerns by users and others about the lack of information on transactions where the assets were derecognised in their entirety. This information would presumably be relevant whether the derecognition took place under IAS 39 or previous GAAP.

Practical implications

Prior to the release of the Amendments, IFRS 7 did not require disclosures about derecognised assets. The IASB believes that by providing disclosures about assets derecognised in their entirety, it is providing users with useful information about the risks associated with an entity's continuing involvement in such assets, including the amount, timing and uncertainty of the entity's future cash flows. However, materiality considerations would need to be taken into account in determining the need for or the extent of disclosure.

³ On 20 December 2010, the IASB issued Amendments to IFRS 1 by changing the reference to 1 January 2004 to 'date of transition.' This Amendment is only available to entities who convert to IFRS in annual periods beginning on or after 1 July 2011.

Appendix

The following is a list of the more pertinent disclosures required by the Amendments for assets derecognised in their entirety, but where the entity still has continuing involvement in them:

- ▶ The carrying amount of the assets and liabilities recognised in the statement of financial position, representing the entity's continuing involvement and their fair value
- ▶ An estimate of the maximum exposure to loss from the continuing involvement (including a description of how this was determined)
- ▶ The total undiscounted cash flows that would or may be required to repurchase derecognised financial assets or other amounts payable to the transferee in respect of the derecognised assets, together with a maturity analysis of such cash flows

If an entity has more than one type of continuing involvement in similar derecognised assets, the disclosures can be aggregated.

Besides quantitative information, qualitative information will also be required. This includes: a description of the derecognised assets; the nature and purpose of the continuing involvement; a description of how the entity manages the risk inherent in its continuing involvement; whether the entity is required to bear losses before other parties (including the ranking and amounts of losses borne by parties whose interests rank lower than the entity's interest in the asset); and a description of triggers associated with obligations to provide financial support or repurchase derecognised financial assets.

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