Deutsches Rechnungslegungs Standards
German Accounting Standards
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Der Standardisierungsrat

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Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

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Dear Sir David

ED 7 – Financial Instruments: Disclosures

We appreciate the opportunity to comment on the draft International Financial Reporting Standard *Financial Instruments: Disclosures*.

General remarks:

We support the objective to propose principle based disclosure requirements for financial instruments, which structure and improve the requirements of IAS 30 und IAS 32. We agree to reducing detailed existing disclosure requirements in order to increase the overall quality of the disclosures.

As a revision of IAS 30 would only be limited to banks and similar financial institutions, we support the Board's aim to provide guidance on disclosure and presentation issues that arise for all types of entities that engage in financial activities. However, extending the scope and introducing new quantitative disclosures about the extent of risk arising from financial instruments might cause difficulties for entities in the non-banking sector in collecting and publishing data, e.g. concerning the credit risk, the fair value of collateral and other credit enhancements by each class of financial instruments. In some cases, which we will describe below, there is doubt whether the cost and effort necessary to comply with these requirements are appropriate in the light of the decision usefulness.

Vorstandsausschuss:
Prof. Dr. Harald Wiedmann (Vorsitzender), Dr. Helmut Perlet (Stellvertreter), Dr. Werner Brandt (Schatzmeister), Heinz-Joachim Neubürger
Generalsekretärin: Liesel Knorr

At this time, we would like to see IASB taking up the project of Management Commentary (Management's Discussion and Analysis) on its active work programme. For example, in December 2002 IASB 's Financial Activities Advisory Committee recommended to disclose financial risks within the Financial Statements (which is proposed in ED 7) while operational risk disclosure should become an input to MD & A. This recommendation included both qualitative and quantitative information. The European Union decided to introduce periodic management reporting of issuers as a kind of European counterpart to the MD & A required by the SEC filing rules. GASB strongly supports an IASB project proposal in order to avoid inconsistent developments of the European requirements and practice and other capital markets. This should also be the central issue of IOSCO, having issued principles on Management's Discussion and Analysis in February 2003.

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance:

The draft IFRS incorporates disclosures at present contained in IAS 32 *Financial Instruments: Disclosure and Presentation* so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).

(b) information about any allowance account (see paragraphs 17 and BC14).

(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).

(d) fee income and expense (see paragraphs 21(d) and BC17).

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

GASB's comment:

Given the different measurement bases in IAS 39 for each class of financial instruments, the proposal to disclose information on financial assets and financial liabilities by classification and income statement gains and losses by classification is appropriate. This will enable users to understand better the financial performance of an entity's financial instruments.

We appreciate that IAS 30 will be superseded, and that some detailed disclosures previously required by IAS 32 (eg the effective interest rate on the liability component of multiple embedded derivatives: old 32.94 (d)) are abolished.

Concerning par. 17 b, we would like to address an improvement of disclosures about impairment. Disclosure on financial assets impaired by credit losses is required only when an allowance account is used. On the other hand, disclosure is not required on financial assets whose carrying amount is reduced directly. These disclosures are not entirely new but originate from the requirements in IAS 30.43. However, this could encourage preparers of financial statements to use the latter method of credit provisioning. Whichever method is applied, information on credit losses for each class of financial assets is useful for assessing impairment losses for entities and for comparing one entity against others. Additionally, we regard this information as useful because ED 7.22 no longer requires disclosing the nature of impairment losses, currently contained in IAS 32.94 (i).

Question 2 – Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC 27 and BC 28).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

GASB's comment:

The disclosure requirement of the fair value of collateral pledged as security and other credit enhancements (par. 39 (b) and 40 (c)) relates to requirements of the Basel Accord for banks and similar financial institutions. The proposal in ED 7 is appropriate for financial institutions. In our view, it goes beyond the requirement of IAS 30.53, which the table of concordance of ED 7 shows as broadly addressing the same matter.

However, we doubt whether entities can provide the proposed disclosures for all activities, specifically for those outside the banking sector, in detail. This concerns especially disclosing fair values both separated by each class of financial instrument and, according to par. 39 (b) and 40 (c), additionally separated by financial assets that are either past due or impaired and financial assets with credit risk that are neither past due nor impaired.

Furthermore, there is uncertainty which kind of legal contracts is regarded as relevant "collateral pledged as security and other credit enhancements" for

disclosure. For example, industry might have problems to collect data of fair values of goods sold with a retention-of-title clause.

According to IAS 32.76 and 32.80-32.81, disclosure about the exposure to credit risk includes information concerning master netting arrangements that serve to mitigate its exposure to credit loss but do not meet the criteria for offsetting. Par. 39 and 40 go much further. We agree that information about the loss the entity expects to incur in the event of default is useful for economic decisions. However, we doubt whether the comparison of the added fair values of collateral obtained and the financial assets provides adequate information. In practice, collateral pledged relates to a certain financial asset and it might even exceed the book value of the financial asset in some cases. Regularly, the fair value of collateral is only a percentage of the book value of the financial asset. Adding these fair values might be misleading for the users, because the maximum credit risk of a certain financial asset depends on the fair value of collateral obtained for this specific asset.

Thus, we propose to reconsider the requirement of disclosing the fair value of collateral pledged even though the Board concluded that disclosure of the fair value is not required when impracticable. Qualitative information about collateral pledged would be sufficient information for users. This should include disclosure about the percentage of the financial assets secured.

If the Board does not agree to deleting the requirement to disclose the fair values, we recommend considering adding more guidance on the interpretation of "impracticable" in IG 16, which focuses on the aspect of undue cost and effort. This should include examples of activities outside the banking sector. For example, we regard the disclosure of fair values of plant and equipment sold with a retention-of-title clause as being impracticable, because regularly the selling price of these goods would not be the fair value of the collateral.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC 36-BC 39).

Is the proposed disclosure of a sensitivity analysis practicable for all entities?

If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

GASB's comment:

We appreciate that ED 7.43 et seq. no longer requires disclosing the effective interest rates for financial assets and financial liabilities (old IAS 32.67-69, 32.94 d). Since the interest rate risk is part of the market risk, the table of concordance indicates that these paragraphs have been substituted by the requirement to disclose a sensitivity analysis.

For most entities, the sensitivity analysis is an integral part of their management process. The analysis reveals the sensitivity with which the performance of the portfolio responds to a change in risk factors. We support the proposal to require a single factor analysis only, and to permit the disclosure of multifactor analysis when management uses such an analysis to manage risk. In many cases, a complex multifactor analysis might be more realistic in the light of interaction and interdependencies of risks, but such an analysis is also more complex and costly to prepare.

Par. 43 requires showing the effect of reasonably possible changes in the risk variable on profit and loss or on equity at the reporting date. We recommend clarifying, for example in IG 34, that the analysis should not include the possible effect of projected or planned hedging activities in the coming financial year and does not have to relate to projected or budgeted profit and loss or equity. Additionally, it might be useful to add a paragraph in the implementation guidance which explains the meaning of "reasonably possible changes" in the variable (par. 43 a). For example, the Securities and Exchange Commission of the United States requires using near-term changes which means a period of time going forward up to one year and, absent economic justification for the selection of a different amount, changes that are not less than 10 percent of end of period market rates [Regulation S-K, Item 305 (a) (1) (ii) in conjunction with the Instructions to Par. 305 (a) (3) (A-C)].

Instead of disclosing sensitivity analysis, another measure such as the Value-at-risk (VAR) approach could be applied. The majority of all internationally active banks apply this method for measuring market risk, and the method is also explicitly permitted to quantify risks under US GAAP. Par. 44 allows using a sensitivity analysis that reflects interdependencies between risk variables, if

management uses it to manage its exposure to financial risks. The Implementation guidance IG 35 names the Value-at-risk methodology in the context of disclosing the type of model used and the main assumptions only. The VAR indicates the maximum loss in value of a portfolio with a given degree of probability (confidence level). It provides valuable information on the risk profile of the entity and, at the same time, this is not as sensitive as a sensitivity analysis. Besides, the VAR is also required for regulatory reporting under the Basel Accord. Therefore, we recommend introducing one sentence in par. 44 that clearly states that disclosing VAR might be used instead of a sensitivity analysis.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45-BC54).

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

GASB's comment:

Information about what constitutes capital, the level of an entity's capital and how it manages capital are important towards assessing the risk profile of an entity and its ability to withstand unexpected adverse events. The banking industry is subject to externally imposed capital requirements (in line with the requirement of the New Capital Accord of the Basel Committee). As such, the proposal for compliance with externally imposed capital requirements is appropriate. As regards the entity's supervisory dialogue and the confidentiality between the regulator and the entity, we recommend not requiring disclosure when the entity did not comply with the externally imposed capital requirements for a short period during the financial year only.

However, we are of the opinion that capital targets set internally by management should not be required for disclosure. This is especially the case where the industry is already subject to external requirements. Additionally, internally imposed requirements are targets set by management (as in budgeting

exercises). Therefore, we are concerned whether such disclosure would improve the value of information to users of financial statements, but rather mislead users in arriving at the wrong conclusion. Compared to other internally set financial targets like return on investment or profit, we cannot see why the internal capital target should be more important than others and whether its disclosure in isolation would improve the users' understanding of the future development of the financial performance and position.

In case the IASB does not agree with these arguments against the disclosure of capital targets set internally by management, we recommend reconsidering the wording of the requirements in par. 47-48 and the illustrative example of IE 1 in the implementation guidance. In our view, it is not clear what "capital targets set by management" include. On the one hand, par. 47 (b) requires to summarise quantitative data about any capital targets. Due to our interpretation of "target", this would require the disclosure of future-oriented key ratios or indicators. Since forward-looking information is always uncertain, we would recommend to require the disclosure of ranges of targets and additional explanations, especially about the time horizon which should not be short-term but medium-term. On the other hand, the illustrative example seems to cover the period under review and the previous period only, without proposing the disclosure of capital targets for the next financial year. Additionally, it seems to focus on the dividend policy of the company rather than the capital management and the capital targets.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62 – BC67).

Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B paragraph B9).

Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

GASB's comment:

The proposed transition exempting first time adopters of IFRSs from providing comparative disclosures is appropriate. However, we recommend that all entities that choose to apply the IFRS before 1 January 2006 should be exempt from the requirement to produce comparative information in the first year of application.

Since ED 7 will not be finalised before the first quarter of 2005, some entities that would like to apply the proposed new risk disclosures early may not have all the information needed to provide comparative disclosures for 2004.

Question 6 – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

GASB's comment:

Under European law, all public or private limited companies are required to publish a management report, irrespective of whether they are listed on the capital market or not. This management report includes a section about risk reporting. The section requires information about financial risks in relation to the use of financial instruments and, where material for the assessment of assets, liabilities, financial position and profit or loss, the financial risk management objectives and policies, including policies for hedging each major type of forecasted transactions for which hedge accounting is used, and the exposure to price risk, credit risk, liquidity risk and cash flow risk. A more detailed German Accounting Standard, GAS 5, has been applicable since 2001. Compared to IAS 32 it has a much more general approach to risk reporting, because it requires disclosures about type of risks – including operational risks – and the overall risk management system.

Because the management report is outside the scope of the EU-IAS Regulation, which requires all listed companies to apply IAS to their consolidated accounts, the annual report is a necessary addition to the annual IFRS-financial statements of European companies after 2005. This might cause a duplication of information in the notes and the management report, unless national legislators find other practical solutions, which is the case in Germany.

Since financial risk reporting is an integral part of IAS 32 and the Research project "Management commentary" is still ongoing, we agree that the disclosures proposed by the draft IFRS should be part of the financial statements. However, we recommend reconsidering this question once the Management commentary project is on the IASB active project agenda.

Question 7 – Consequential amendments to IFRS 4
(paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57 – BC61.

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

GASB's comment:
We do not agree that consequential amendments should be made to IFRS 4 before phase II of the insurance project. It seems to be not easy for many entities to implement further changes in their financial reporting in such a short timeframe. Additionally, some of the proposed disclosures require further evaluation of their applicability regarding the insurance business.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42-BC44).

Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

GASB's comment:
We are of the opinion that the Implementation Guidance is sufficient.

However, it would be helpful if the IASB could provide an example illustrating how the fair value of the financial liability that is not attributable to changes in

benchmark interest rate can be estimated using the steps as illustrated in paragraph 12 (a) to (d).

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards Fair Value Measurements published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards Fair Value Measurements, which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:

For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)

- (i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,
- (ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
- (iii) the effect of the remeasurements on earnings for the period (unrealised gains or losses) relating to those assets and liabilities still held at the reporting date.

For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of

- (i) the reason for remeasurements,
- (ii) the fair value amounts,
- (iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
- (iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.

Disclosures similar to (a) (ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a) (iii) are proposed in paragraph 21(a).

Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

GASB's comment:
We believe that the requirements in the draft IFRS provide adequate disclosure of fair value when compared with those proposed in the FASB's Exposure Draft.

Question 10 – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

GASB's comment:

Further guidance could be provided by the IASB on the interpretation of 'unrepresentative' of the quantitative information at the reporting date regarding the entity's exposure to risk during the period (paragraph 36).

Paragraph 34 and 35 require qualitative disclosures for "each risk arising from financial instruments". We think that information is only necessary about "each type of risk…" since, for example, the objectives, policies and processes for managing the risk relate to one type of risk arising from financial instruments. Accordingly, par. 43 (a) requires a sensitivity analysis for each type of market risk.

We do not have any further comments.

If you would like any clarification of these comments, please contact me.

Yours sincerely,

Prof. Dr. Klaus Pohle
President