Organismo Italiano di Contabilità – OIC (The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

22 October 2004

Re : ED 7 Financial Instruments: *Disclosure*.

Dear Sir David,

We are pleased to provide our comments on the draft reply to EFRAG, which deals with the ED 7 Financial Instruments: *Disclosure*.

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?

<u>EFRAG Response</u>

We note that the above proposals are not entirely new but to some extent originate from the existing requirements in IAS 30 and IAS 32. Namely:

? disclosures in point (a) in question 1 (paragraph 10) partially come from existing IAS 32.94 (e);

- disclosures in point (b) (paragraph 17) regarding the allowance account were required by IAS 30.43;
- disclosures in point (c) (paragraph 21 (a)) are similar to the current requirements in IAS 32.94 (h); and
- disclosures in point (d) (paragraph 21 (d)) were required by IAS 30.9.

We find all the above mentioned disclosures and the additions appropriate.

At the same time, we find that the omission of some requirements previously required by IAS 32 might disguise information which could be potentially important for users of financial statements.

The following omissions raise our particular concern:

- **ED 7 Paragraph 18** (old IAS 32.94 (d)): This paragraph no longer requires to disclose *effective interest rate* on the liability component. Furthermore, we note that the requirement to disclose effective interest rate was deleted for all financial assets and financial liabilities. This requirement was previously included in old IAS 32.67-69. The table of concordance indicates that these paragraphs have been substituted by the requirement to disclose the sensitivity analysis. However**,** we believe that the disclosure of effective interest rate has provided important additional input for users especially for the purpose of forecasting future debt burden of the entity and also provided an insight as to how the market rates the credit standing of the entity. Therefore, we believe that the requirement to disclose the effective interest should be reinstated for financial liabilities including compound instruments with multiple embedded derivatives. We agree however that this requirement is not crucial for financial assets.

- **ED 7 Paragraph 22** (old IAS 32.94(i)): This paragraph no longer requires disclosing *the nature* of the impairment loss. We believe it is important for users of financial statements to know what financial assets were impaired and what the nature of the impairment is.

- **ED 7 Paragraphs 21 and 23:** Old IAS 32.66 (c) required to disclose "the basis on which income and expenses from financial assets and financial liabilities are recognised and measured." We believe that this information is important for users of financial statements. Therefore, we recommend it to be reinstated in accounting policies disclosure in paragraph 23 of ED7.

  We note however that paragraph 21 (b) of ED 7 requires to disclose how net gains and net losses are determined. This requirement appears to be similar but narrower compared with the disclosure requirement in old IAS 32.66 (c). If this is the case we recommend that this requirement should be adjusted to encompass old IAS 32.66 (c). We also believe that this paragraph should be rather included in paragraph 23 together with other accounting policies.

- **ED 7 Paragraph 30** (old IAS 32.90): This paragraph no longer contains the requirement to disclose ''if possible, the range of estimates within which fair value is highly likely to lie''. We believe that this information is important for users and should be reinstated.

<u>OIC Response</u>

In our opinion, the disclosure proposed in the draft IFRS is appropriate. However, we would like to make some comments concerning the points raised by the EFRAG.

- ? We do not consider necessary the amendment proposed by the EFRAG regarding the reinstatement of the disclosure of the effective interest rate for liabilities contained in IAS 32. Indeed, para. BC39 of the draft IFRS clarifies the fact that the intention of the Board is substitute the disclosure content of paras. 67-69 of IAS 32 (contract terms and effective interest rates) by recourse to sensitivity analysis. More generally, we would point out that the need to keep the effective interest rates on market rated liabilities "under control" is in any case covered by the disclosure required under para. 12 of the draft IFRS. Undoubtedly, the requirement to illustrate the "sensitivity" to changes in interest rates on assets and liabilities seems to be more complete and appropriate compared with the previous disclosure concerning future redefinitions of the interest rates of the assets and liabilities included in the financial statements.
- ? We agree with the comment by the EFRAG on para. 22 of the draft IFRS concerning the greater clarity of para. 94i of IAS 32.
- ? We agree with opinion expressed by the EFRAG on reclassifying the criteria for determining the gains and losses relating to financial instruments from para. 21 to para. 23 of the draft IFRS. Moreover, the wording used in para. 66 of IAS 32 appears to be clearer than that in para. 21 of the draft IFRS.
- ? We can agree with the comment by the EFRAG in favour of reinstating that part of para. 90 of IAS 32 that requires an indication of the range within which it is reasonable to place the fair value of a capital instrument not valued at fair value, unless it is objectively impossible to determine a credible range.

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, BC27 and BC28). Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

EFRAG Response

We agree with the proposal.

OIC Response

From a theoretical point of view, the requirement to disclose the fair value of collateral pledged as security for credit risk in the financial statements seems to be correct and reasonable. However, it should be noted that this may place a very considerable burden on entities. Therefore, it should be specified that said disclosure should be made only in those cases where the difference between the nominal or book value and the respective fair value is significant.

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 BC36-BC39). 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?

<u>EFRAG Response</u>

We agree with the proposal that entities should disclose a sensitivity analysis to explain their exposure to market risk. We believe that it is also important that the Standard should not include any additional restrictions on how entities should perform this analysis.

However, we have a general comment that risk disclosures required by ED 7 are based on the presumption that risks are discrete whereas in fact they often interact. Therefore, the proposed single factor analysis might result in oversimplification of a more complex multifactor reality. Such analysis may produce a misleading volatility pattern (e.g. too low) which will be unrepresentative of the actual exposure to market risk of the entity. We recommend that the IASB addresses this fact in the finalization of the Standard.

Question to constituents: ***Our current position is as expressed above. However, we would like to ask constituents to provide feedback to us if you believe that for some entities a sensitivity analysis is not practicable to implement and, if this is the case, what would be an alternative disclosure which would equally enable users to evaluate the nature and extent of market risk?***

<u>OIC Response</u>

We agree with the new requirement proposed by the draft IFRS on the sensitivity analysis of market risk. In particular, we support the conclusions reached in paras. BC36-39, which indicate a greater simplicity of such a disclosure by using summary indicators rather than the presentation in tabular form required by IAS 32 paras. 60 (a), 67 (a) and (b), intended to enable the users of financial statements to evaluate for themselves the nature and extent of market risk inherent in an entity's financial statements. Furthermore, concerning the point raised by the EFRAG about the use of VAR methods, our view is that it is already possible to take account of risk variable interdependence and to use said methods to meet the disclosure requirement on market risk and that this is covered by para. 44 of the draft IFRS.
However, it should also be noted that some types of commercial and manufacturing entities could encounter difficulties in providing information of this kind. Generally speaking, it would be necessary to make this disclosure compulsory for entities that employ financial instruments in widespread use.
Undoubtedly, this issue needs to be re-examined when considering small and medium-sized entities, as it would not be reasonable to extend this kind of disclosure requirement to them.

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?

<u>EFRAG Response</u>

We support the proposal to disclose information regarding externally imposed capital requirements. However, we are aware that in some countries disclosure of incompliance may not be favored by regulators who establish this type of targets.

However, we believe that the disclosure with regard to capital requirements set internally is not necessarily needed. Companies usually consider internally set capital targets together with other financial targets which are equally important. The requirement to present only capital targets in isolation would not be particularly useful for users of financial statements because this would reveal only a part of the whole picture. Moreover, this information may be considered too sensitive for an entity to disclose.

Therefore, we do not support a compulsory disclosure of internal capital requirements. In addition, in our view example IE1 in the implementation guidance focuses on the dividend policy of the company and not on the capital management. We are also nervous that the example may lead to boiler plate and simplistic disclosure. If the IASB removes the disclosure requirement of internal capital targets the example will not be needed. Otherwise, we recommend that the IASB considers adjusting the example.

<u>OIC Response</u>

We agree with the response provided by the EFRAG. The proposed requirement to make public disclosure about capital objectives set by regulators, as a result of recommendations requested in confidentiality, appears inopportune. Moreover, we are of the opinion that the disclosure regarding internally set capital requirements is particularly delicate as well as price sensitive and that therefore its inclusion in the financial statements should not be compulsory but left to the entities' discretion.

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?

<u>EFRAG Response</u>

We agree with the proposed requirements. However, we recommend that the Standard should clarify when IAS 30 is withdrawn, particularly in the case of an early adoption. We suppose that IAS 30 is withdrawn simultaneously when the Standard is first applied by an entity. We would like that this clarification is added in the Standard to avoid misunderstanding because this has an effect on comparative information.

<u>OIC Response</u>

We agree with the response provided by the EFRAG.

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?

<u>EFRAG Response</u>

We believe that disclosures about risk should be part of the financial statements. We share the supporting arguments described by the IASB in BC41. However, when there is a subsequent Standard on MD&A we would like to be able to consider this question again.

<u>OIC Response</u>

Our view differs from that stated by the EFRAG in that we believe that the disclosure about financial risks should not be included in the notes. Such a disclosure, derived from summary indicators, cannot be readily deduced from the accounting data. Consequently, it would not seem correct to include it in the notes. Rather, as it is management information, it would be more appropriate to include it in the management report, and therefore be covered by a subsequent standard on MD&A. Furthermore, it should be noted that the proposal of the draft IFRS is not in line with the corresponding requirement of the SEC, which includes such disclosure in a special section of the management report.

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?

<u>EFRAG Response</u>

We share the concern that for insurance companies it is not ideal to have further changes in their financial reporting a short time after having prepared for the implementation of IFRS 4. Further changes to disclosure requirements even if mandatory only from 2007 might be burdensome in adjusting systems.

However, we believe that it is a conceptually sound approach to amend disclosures in IFRS 4 at the same time as IAS 32 is revised, because IAS 32 was the main basis for IFRS 4 disclosures.

Furthermore, we are concerned that if the amendments to disclosures in IFRS 4 are delayed until Phase II of the insurance project is finalised, it may take a very long time before harmonisation between financial instruments disclosures and disclosures for insurance contracts is achieved. This might be a competitive disadvantage for insurance companies especially in those instances where the amendments would result in disclosures that are easier to prepare and would be more meaningful for the users.

Similar to our comment to question 3, we would like to note that insurance contracts in reality cover risks which interact and therefore the presumption in ED 7 that risks are discrete is not always workable. For example, a guaranteed annuity rate option has an exposure to both a mortality risk and an interest rate risk. The question is how to separate them to meet the disclosure requirements in ED 7. We recommend the IASB to address how to deal with such situations in the final IFRS and consequential amendments to IFRS 4, if the Board decides to proceed with the amendments in the final Standard.

OIC Response

Regarding the amendments to IFRS4, we do not believe it would be appropriate make a further change to the recently issued standard on insurance contracts, this also in view of the fact that, as is known, this is a temporary standard intended to remain in effect until the finalisation of Phase 2 of the IASB project on insurance contracts.

Were the IASB in any event to decide to make the proposed amendments to IFRS4 for reasons of homogeneity with other financial institutions/instruments, then we would agree with the comment by the EFRAG about the need for greater clarification on how to separate the risks covered by insurance contracts in order to perform the sensitivity analysis required by ED7.

Indeed, as insurance contracts more than other financial instruments lend themselves to the contemporaneous cover of various types of risk, we believe that the generic reference to the possibility of using analyses that take account of risk factor interdependence (para. 44 of ED7) is not adequate to fully address the issue. Rather, we believe that the IASB should provide further and more specific indications in this regard.

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?

EFRAG Response

We believe that the implementation guidance is sufficient. We do not have any additional suggestions for the implementation guidance except for the illustrative example in IE1. Please see our response to question 4.

OIC Response

We believe that the Implementation Guidance provides sufficient information for applying the risk disclosure requirements.

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:

(a) 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.

(b) 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

(i) 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?

<u>EFRAG Response</u>

We agree that fair value disclosures as proposed in ED 7 are adequate compared to those in the FASB's exposure draft.

Question to constituents: *We understand that the purpose of this question is to ensure that there will be no substantial difference between the disclosure requirements in the draft IFRS and the disclosure requirements in the FASB's exposure draft in view of the convergence between IFRSs and the US GAAP. This might be especially relevant for entities which have to provide reconciliation to the US GAAP.*

Do you envisage any differences in the fair value disclosure requirements between ED 7 and the FASB's Proposed Statement that can pose difficulties for entities which have to comply with both IFRSs and US GAAP?

<u>OIC Response</u>

We agree with the response provided by the EFRAG.

Question 10 – Other comments

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

<u>EFRAG Response</u>

We do not have any other comments.

<u>OIC Response</u>

No other comments.

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)