Piercing the corporate veil

In August 2005, the International Accounting Standards Board issued IFRS 7 *Financial Instruments: Disclosures*. Treasurers should be aware of what the standard really means for them and their companies.

IFRS 7 replaces the current disclosure requirements for financial instruments laid down by IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and IAS 32 *Financial Instruments: Disclosure and Presentation.* The objective of IFRS 7 is to provide financial instrument disclosures that enable users to evaluate the significance of financial instruments to an entity's financial position and performance, and the nature and extent of risks arising from financial instruments to which an entity is exposed and how those risks have been managed.

Importantly, IFRS 7 will also require disclosures to be based on information provided internally to key managers. Striking the balance between too little and too much disclosure will be one of the challenges.

IFRS 7 is applicable to all entities reporting in accordance with international financial reporting standards (IFRS) for financial periods beginning on or after 1 January 2007, with earlier application encouraged. Existing users of IFRS that adopted IFRS 7 before 1 January 2006 are required to prepare comparative financial information in accordance with IFRS 7, but are exempted from providing the risk-based disclosures. First-time users of IFRS adopting IFRS 7 before 1 January 2006 will be exempt from providing comparative financial information in accordance with the requirements of IFRS 7.

Just when you think you have managed to navigate successfully the implementation of IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 7 now presents you with yet another set of onerous reporting requirements. IFRS 7 will, however, provide preparers with an opportunity to give users enhanced financial instrument disclosures. The disclosure requirements are designed to enable the user to evaluate the significance of financial instruments on the financial position and performance of an entity and to provide stakeholders with greater transparency in the manner in which financial risk is monitored, measured and managed.

WHY THE CHANGE? In the late 1990s the financial services industry experienced a number of changes, which included the way in which financial institutions and other entities managed their activities and risk exposures. As a result, users of financial statements experienced difficulties in understanding, assessing and benchmarking an entity's financial position, performance, risk exposures and risk management processes. The evolution of risk management practices and the focus on financial instruments by users of financial statements culminated in the development of IFRS 7. As more and more companies involved themselves in activities more commonly associated with the banking world, the International Accounting Standards Board concluded that IFRS 7 should be applicable to all entities that have financial instruments.

The perception that IFRS 7 is simply another set of accounting rules is a gross misinterpretation. IFRS 7 seeks to provide risk-based disclosures from a company's perspective and not merely to require a laundry list of required disclosures, as is currently the case with IAS 32. IFRS 7 will require you to communicate the nature and extent of your risks, the significance of financial instruments, and how you manage financial risks to your stakeholders by explaining your risk objectives, policies and processes.

QUANTITATIVE AND QUALITATIVE DISCLOSURES The disclosures that enable users to evaluate the significance of financial instruments consist of both qualitative disclosures (such as descriptions of derecognised assets, collateral, defaults and breaches) and quantitative disclosures (such as the disclosure of the carrying amounts of the categories of financial assets and liabilities, and the amount of change in fair value of financial assets or liabilities that are designated at fair value through profit or loss that is attributable to changes in credit risk).

The disclosures related to the nature and extent of risk arising

STEPHEN BRICKETT AND **RAMON TOLK** EXPLORE WHY A SINGLE ACCOUNTING STANDARD DEALING WITH FINANCIAL INSTRUMENT DISCLOSURES HAS BEEN DEVELOPED.

Executive summary

- IFRS can be seen to pierce the corporate veil by requiring disclosure of information provided internally to key management personnel and which is used to drive the decision-making process.
- IFRS 7 disclosure requirements are designed to enable the user to evaluate the significance of financial instruments on the financial position and performance of an entity.
- The introduction of the standard reflects the fact that companies are involving themselves in activities more commonly associated with that of the banking world.

from financial instruments also consists of both qualitative and quantitative disclosures.

The qualitative disclosures require a description of each type of risk arising from financial instruments, the exposures to risk, how those risks arise, the risk management objectives, policies, processes and how those risks are measured.

The quantitative disclosures provide data about the exposure to market risk – for example, foreign exchange, interest rates, commodity prices, credit risk and liquidity risk. Importantly, the quantitative disclosures should be based on information provided internally to the entity's key managers.

The level of detail of the disclosed information in the financial statements should reflect the extent to which the entity uses financial instruments and is exposed to risks. This is where IFRS can be seen to pierce the corporate veil by requiring disclosure of information provided internally to key management personnel and which is used to drive decision-making processes.

WHAT HAS CHANGED FROM IAS 30 AND IAS 32? A comprehensive analysis of the differences between IFRS 7 and that of IAS 30 and IAS 32 reveals a number of notable changes:

- A sensitivity analysis discloses how profit or loss and equity would have been affected by changes in risk variables that were reasonably possible at the balance sheet date.
- There are additional disclosure requirements for hedge accounting with regard to ineffectiveness on cashflow and fair-value hedging relationships.
- Information must be provided about the credit quality of financial assets and the credit exposure at the reporting date.
- Various accounting policies must be disclosed, including the manner in which gains and losses have been determined.
- Any day one profit or loss must be disclosed, including the amount yet to be recognised at the beginning and end of the period, and the accounting policy for recognising that difference in the profit or loss.
- The amount of change in the fair value of loans and receivables designated at fair value through profit or loss not attributable to changes in market risk should be disclosed, together with a description of the methods used to calculate these amounts.

The above list is by no means exhaustive and the devil will lie in the detail. While a first impression may be that not much has changed, a comprehensive analysis of the changes and how those changes affect you will influence the number of changes that are required to risk policies, procedures and disclosure requirements.

ON THE SHOULDERS OF TREASURY IFRS 7 will mean more to an entity than merely presenting the accounting function with an additional reporting burden at each financial reporting date. Many of the disclosure requirements will fall on the shoulders of the treasury function since the quantitative disclosures will be based on information provided internally to key managers. Quantitative disclosures, including the market risk sensitivity analysis, will in most instances need to be prepared by the treasury department.

Keith Strachan, Director of Treasury Consulting at Deloitte, says: "To date, many treasurers have existed relatively independently of their financial controller colleagues; some have even managed to avoid IAS 39 entirely. In some respects IFRS 7 may seem like a conspiracy to bring treasurers and financial controllers ever closer together."

Only when you have acquired a comprehensive understanding of the type and number of financial instruments that an entity has, the risks that those instruments expose the entity to and what your risk mitigating techniques are, can you fully digest the impact that IFRS 7 will have on your financial instrument disclosures.

SENSITIVITY ANALYSIS The sensitivity analysis will be a powerful disclosure tool. This is because it is easily understood and is expected significantly to improve the user's understanding of the financial performance and position of an entity by enabling the impact of those risks on the amount, timing and uncertainty of future cashflows to be evaluated.

IAS 32 contained a similar requirement, albeit it was only a recommended item of disclosure. Now as a required disclosure item, it is expected to pose significant reporting challenges.

Strachan says: "Many treasurers have traditionally relied on banks and other third-party tools to value derivatives and assist with effectiveness testing. The sensitivity analysis will provide a further challenge to treasurers in sourcing the analysis. It may be that tools will become available, but a back-up plan would seem prudent at this point."

Policies and reporting processes will also require development. For instance, an entity will need to develop methodologies to determine the changes it considers to be 'reasonably possible' and to be able to provide reasons for changes in any of its methods and assumptions. Such considerations will need to be supported by empirical evidence as they can expect to be challenged by an entity's auditors.

HOW MUCH TO DISCLOSE? A concern raised by many is exactly how much information should be disclosed. There has been a notable shift away from the mandatory disclosures of IAS 32 to one that reflects the significance of financial risks and how management perceives and reports those risks as required by IFRS 7.

The extent of disclosure provided by an entity in accordance with IFRS 7 will depend on the extent to which it uses financial instruments and has assumed risks. Many of the quantitative-based risk disclosures of IAS 32 have been eliminated, with IFRS 7 now requiring disclosure of information based on information reported internally to key managers.

Strachan says: "With few required disclosures, the open-ended nature of IFRS 7 may at first seem ideal for many treasurers who tend to follow a 'less is better' philosophy with regard to external reporting. This temptation to disclose minimal information and to make the vague motherhood statements typical under previous GAAP leaves open the risk of external stakeholders deeming this to mean management is not appropriately managing or, worse, understanding the risks in the business."

This begs the question as to how much disclosure you should give – striking the balance between too little or too much will be the challenge. For instance, some entities have noted that IFRS 7 does not contain mandatory interest rate risk disclosures. Some entities consider that no disclosures should be provided, while others have indicated a desire merely to continue providing disclosures in line with IAS 32. Both approaches have their pitfalls.

- Simply not disclosing financial information because it is not mandated by IFRS 7 is contrary to the requirement to disclose quantitative data based on information reported internally to key managers. Stakeholders may frown on the absence of risk-based disclosures since they will perceive those entities as not sufficiently managing the risks that they are exposed to.

- Nor will merely continuing to report risk disclosures as required by IAS 32 satisfy the requirement that the information be based on that reported internally to key managers.

Inevitably, the tension between the two extremes will result in discussions with your external auditors who are tasked with providing an opinion on the entity's compliance with IFRS.

OTHER IMPACTS Strachan says: "This is the time for treasurers to review their policies and internal risk reporting in the light of the requirement to disclose this information externally." Those risk policies, frameworks and reporting functions will need to be enhanced to ensure that information generated reflects the extent to which management monitors financial risk and the extent to which the entity has financial instruments. Other considerations include:

- It will be necessary to develop risk policies and risk reporting frameworks that are consistent with the requirements of IFRS, especially the recognition and measurement criteria of IAS 39. It will also be necessary to ensure that information provided can be reconciled to financial statements.

- The reporting of qualitative and quantitative data will need to be aligned with risk policies and risk reporting frameworks. The treasury and accounting functions will therefore need to work ever more closer to consolidate their reporting requirements.

SUGGESTED IMPLEMENTATION STEPS An implementation plan to comply with the requirements of IFRS 7 will be significantly affected by the nature and extent of a company's financial instruments and exposure to financial risks. You should incorporate the following steps into your implementation plan:

- Understand the disclosure requirements of IFRS 7 and how they differ from that of IAS 30, IAS 32 and previously adopted GAAP, and the effect of those disclosure requirements on the financial statements.

- Provide training to all stakeholders to understand the requirements of IFRS 7 and more importantly the impact of those changes on all areas of the business.

- Review existing management information reporting processes, risk policies and frameworks to understand the current basis upon which disclosures will be provided. Those processes, policies and frameworks may require amendment to provide a basis on which external disclosures can be provided.

- Develop or invest in processes and systems to provide information to support the internal risk reporting requirements on which external disclosures will be based as well as the market risk sensitivity analysis.

- Prepare a draft set of annual financial statements that incorporate the requirements of IFRS 7 and agree the nature and extent of disclosures with your auditors.

- Test the internal controls surrounding the key processes used to generate the required financial information. In some cases it will be necessary to ensure that controls, processes and procedures comply with the requirements of Sarbanes-Oxley.

CONSISTENT APPROACH IFRS 7 presents entities with a number of challenges to both the accounting and treasury functions. Never before has it become quite so important to ensure that treasury risk reporting is consistent with the disclosures provided externally to key stakeholders. Consistency in qualitative, quantitative and other disclosures will be required and can be fostered only through closer communication channels between the treasury and accounting functions of an organisation.

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