

IFRS 7 – ready or not*

Are you ready to report on your risks and how you are managing them?



What is IFRS 7?

IFRS 7, *Financial Instruments: Disclosures*, consolidates and expands a number of existing disclosure requirements and adds some significant and challenging new disclosures. It is applicable for annual periods beginning on or after 1 January 2007, with prior year comparatives required. Some of the requirements of IFRS 7 will be familiar due to the fact that it is, in part, a replacement of IAS 32, *Financial Instruments: Presentation*, while others – such as the requirement to provide quantitative and qualitative market risk disclosures – are new and may represent a significant challenge for many.

Many entities have not yet focused on the extent of the expanded disclosures or the systems and processes required to produce them. Some entities may also be unaware of how they will be impacted by the requirement to disclose internal company management information externally.

Outlined below are some of the key elements of IFRS 7 to help you understand its impact, who the standard applies to and how urgently it needs to be tackled.

Fact or fiction: Test your IFRS 7 knowledge

<p>IFRS 7 requires public disclosure of certain management information to allow shareholders to view financial instruments and risk management activities 'through the eyes of management'.</p>	<p>Fact The standard requires entities to report in their external financial statements the metrics they use internally to manage and measure financial risks.</p>
<p>IFRS 7 only applies to banks and other financial institutions.</p>	<p>Fiction IFRS 7 applies to all entities that have financial instruments. For banks and other similar financial institutions, the requirements of IFRS 7 replace the disclosure requirements currently found in IAS 30, <i>Disclosures in Financial Statements of Banks and Similar Financial Institutions</i>, while for insurance companies, IFRS 7 also amends certain disclosure requirements currently found in IFRS 4, <i>Insurance Contracts</i>. Entities that have not been subject to the disclosure requirements of either of these standards will now be subject to the same reporting requirements as companies in the financial services industry in respect of disclosures for financial instruments.</p>
<p>IFRS 7 introduces an unprecedented level of market sensitive disclosures.</p>	<p>Fact IFRS 7 requires reporting entities to disclose the sensitivity of their results to movements in market risks as a consequence of their financial instruments. The standard also contains new disclosures on risks and risk management and enhanced disclosure of financial instruments. In addition, the standard that outlines financial statement presentation requirements (IAS 1, <i>Presentation of Financial Statements</i>) has been amended to require entities to disclose objectives, policies and processes used for managing capital.</p>
<p>IFRS 7 only impacts entities that use derivative financial instruments or have sophisticated treasury operations.</p>	<p>Fiction IFRS 7 impacts any entity that holds financial instruments including simple instruments such as borrowings, accounts payable and receivable, cash and investments.</p>
<p>There are many additional disclosures that an entity will need to make in order to comply with IFRS 7.</p>	<p>Fact IFRS 7 supersedes the disclosure requirements of financial instruments standards IAS 32 and IAS 30, and adds a whole host of new disclosure requirements.</p>
<p>IFRS 7 isn't a priority for entities now as it applies in 2007.</p>	<p>Fiction IFRS 7 is applicable for financial years starting on or after 1 January 2007, so entities should begin collecting the required disclosure information now.</p>

What are the big IFRS 7 issues?

To adequately address the disclosure requirements of IFRS 7, entities should:

- Be aware that IFRS 7 requires disclosure of how their results would have been affected if market conditions (such as the level of interest rates, exchange rates, commodity, equity or other price risks) were to move by reasonably possible amounts from where they were at reporting date.
- Assess whether they need to develop new systems and processes to capture the required data for some of the more challenging IFRS 7 disclosures.
- Consider whether the systems used to produce the required disclosure information are subject to the appropriate level of internal control for financial reporting purposes, including the audit.
- Be aware that IFRS 7 requires disclosure of the information used by key management to measure and manage risk.
- Develop a communications plan that clearly articulates their strategy for holding financial instruments, how risks from those instruments are managed and how financial instruments are incorporated into the overall value creation strategy.

Meeting the IFRS 7 challenge

There may be as many as 70 additional disclosure requirements in IFRS 7 for which information is not readily available from the accounting systems of a typical corporate.

To help understanding of these disclosures, we have outlined below answers to some of the questions that we are most commonly asked.

Frequently asked questions	Some key considerations
When should my company adopt IFRS 7?	IFRS 7 applies to financial years beginning on or after 1 January 2007 and it requires comparative information for the prior year. For those entities with a 31 December 2007 or 30 June 2008 year end, comparative information is required in respect of financial years to 31 December 2006 and 30 June 2007, respectively.
What financial instruments and risks is my company exposed to?	<p>Entities should ensure that the scope of their disclosures covers all financial instruments and related risk management activities, including capital management. Some of the more common financial instruments that fall within the scope of the standard are cash and cash equivalents, investments, trade payables and receivables, borrowings and derivatives.</p> <p>Entities should consider how these instruments would be affected by movements in market risks (such as interest rates, foreign currency exchange rates, equity, commodity prices and credit) and set their objectives, policies and processes to manage risks from these financial instruments.</p>
What is 'best practice' reporting under IFRS 7?	<p>We expect best practice reporters to provide stakeholders with a complete picture and a clear understanding of the company's financial position. This would include not only information relating to the quantitative measures of potential financial statement impact, but also the rationale for holding financial instruments in the context of the overall business and financial risk management strategy.</p> <p>Entities should consider their market communications strategy and identify whether additional disclosures can add value or are simply a compliance disclosure. This is particularly important where the market is interpreting a new disclosure that hasn't been previously reported.</p> <p>Entities should also strive to answer the perennial question for key stakeholders: how does the use of financial instruments enhance shareholder value?</p>
Who are my company's key internal and external stakeholders?	<p>Entities should identify their internal stakeholders by considering those who: prepare the financial information; are responsible for monitoring that information; and are charged with governance and oversight of that information.</p> <p>Identification of external stakeholders will help determine the sophistication and depth of the required level of disclosure, and might include shareholders, investors and financiers, analysts, regulators, ratings agencies and the media.</p>
How should my company source the required information from internal systems?	<p>First, entities should review their current reporting systems to determine whether the required disclosures are either readily available or can be made available with minor modifications. In the instances where the necessary information cannot be obtained from existing systems, entities should implement a plan around how new information will be collected.</p> <p>This plan might incorporate the development of tools such as quantitative models that perform sensitivity calculations on data extracted from existing systems. Depending on the extent of analysis required, these tools could range from spreadsheets to sophisticated treasury and risk management systems.</p>
Which of my staff do I need to train?	<p>Companies need to identify the staff who will be integral to the production of the information to be disclosed. This will include the financial reporting function and the teams that manage risk (such as treasury, corporate finance and other risk management functions) and external communications (investor relations function).</p> <p>The extent of training and whether this need can be met in-house or will require assistance from external providers will depend on the level of complexity of the financial instruments used by the entity. Either way, ensuring that staff and management gain a deeper understanding of the implications of financial risks on the entity's financial health is a positive outcome for the company and its shareholders.</p>

IFRS 7 disclosure: key requirements explained

Outlined below are some of the more significant disclosure changes that companies will need to prepare for – this is not an exhaustive list of the comprehensive disclosures required by IFRS 7.

Determination of the criteria used to classify financial instruments

Entities will need to disclose the measurement basis or bases used, and the criteria used to determine classification for different types of instruments.

The IFRS 7 application guidance requires specific disclosures to be made, including the criteria for:

- Designating financial assets and liabilities at fair value;
- Designating financial assets as available-for-sale; and
- Determining when an impairment is recorded against the related financial asset or when an allowance account is used.

Disclosure of the components of the fair value movement for items classified as fair value through profit and loss

Where financial assets or liabilities are carried at fair value through profit and loss (FVTPL), IFRS 7 requires disclosure of the breakdown of the change in the fair value of these items. This would include, for example, showing the split between changes due to benchmark market rate movements and credit. For example, where a company invests in an interest bearing corporate bond, the change in the fair value of that bond will be due, in part, to movements in benchmark interest rates (eg, BBSW or LIBOR) and any changes in the credit worthiness of the issuing corporate.

Disaggregating the fair value movements into these two components is likely to be a significant systems challenge for many. At the same time, it will provide investors and users of the financial statements with an unprecedented level of information about the credit quality and trends of the entity's investments. Where companies elect to designate their own liabilities (such as bonds they have issued) at FVTPL they will be required to inform investors about the impact that movements in their own credit quality have had on the value of those bonds.

Discussion of the capital management strategy

Simultaneously to the release of IFRS 7, an amendment was made to IAS 1, *Presentation of Financial Statements*. This relates to capital management disclosures that companies may opt to combine with their risk management information for IFRS 7 disclosure purposes.

The main requirements are to disclose quantitative and qualitative information about the entity's objectives, policies and processes for managing capital. When subject to external regulatory requirements, a statement of compliance is also required. This introduces a significantly enhanced level of disclosure about a company's capital management strategy, as well as the implications of its regulatory requirements.

Best practice will be to present a clear and well defined picture of how the strategy enhances shareholder value, while meeting regulators' expectations.

Qualitative disclosures about risks faced and the strategies used to manage them

For each type of risk (credit risk, liquidity risk and market risk) a qualitative narrative is required. This should:

- identify the risk exposures of financial instruments and how they arise;
- identify the objectives, policies and processes for managing the risks and methods used to measure risk; and
- describe any changes from the previous reporting period.

In conjunction with the required quantitative disclosures (see below), this is perhaps one of the most significant disclosures introduced by IFRS 7. Essentially, IFRS 7 requires the company to tell the world what risks weigh on the minds of management and what it is doing about them. It follows that those who have a good story to tell, and tell it clearly, will potentially be rewarded in the marketplace.

Quantitative disclosures about the potential impacts of market risks

- For each type of risk, entities must disclose summary quantitative data on risk exposure at reporting date, based on information provided internally to key management personnel and any concentrations of risk.
- Entities must also ensure they disclose the following information related to credit risk, liquidity risk and market risk:

Credit risk

- An entity's maximum exposure to credit risk and any related collateral held.
- Information on credit quality of assets that are neither past due or impaired.
- Analysis of the age of financial assets that are past due but not impaired.
- Analysis of financial assets that are individually determined to be impaired.

Liquidity risk

- A maturity analysis for financial liabilities showing the remaining contractual maturities and a description of the approach to managing the inherent liquidity risk.

Market risk

- A sensitivity analysis for each type of market risk (currency, interest rate and other price risk) to which an entity is exposed at reporting date. This should illustrate how profit or loss and equity would have been affected by 'reasonably possible' changes in the relevant risk variable, as well as the methods and assumptions used in preparing such an analysis.
- Any changes in methods and assumptions from the previous period and reasons for such a change.

If you would like an illustrative sensitivity disclosure analysis, please email: sarah.grey@uk.pwc.com

Global thought leadership and IFRS tools



IFRS News

IFRS News is a monthly newsletter focusing on the business implications of the International Accounting Standards Board's (IASB) proposals and new standards.



World Watch – Governance and corporate reporting

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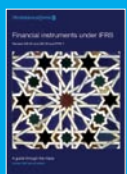
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IFRS Tools and Publications

Details of PricewaterhouseCoopers 2006 tools and publications relating to IFRS and corporate governance. Includes an order form to request hard copies. Visit www.pwc.com/ifrs for electronic copies.

Global IFRS technical publications



Financial Instruments under IFRS – Revised IAS 32 and IAS 39 and IFRS: A guide through the maze

Summarises the revised financial instruments standards and IFRS 7 for existing IFRS preparers and first-time adopters.



IFRS Measurement Checklist 2006

Outlines the measurement bases required by all IFRSs published up to September 2006.



IAS 39 – Derecognition of financial assets in practice

Explores one of the most difficult aspects of IAS 39, outlining requirements for derecognition of financial assets and providing answers to frequently asked questions.



IFRS Disclosure Checklist 2006

Outlines the disclosures required by all IFRSs published up to September 2006.



IAS 39 – Achieving hedge accounting in practice

Covers the practical issues in achieving hedge accounting. It includes answers to frequently asked questions and step-by-step illustrations of how to apply common hedging strategies.



IFRS Pocket Guide 2006

Provides a summary of the IFRS recognition and measurement requirements, including currencies, assets, liabilities, equity, income, expenses, business combinations and interim financial statements.

Global IFRS industry publications



Reporting under the new regime: A survey of 2005 IFRS insurance annual reports

The findings of this survey underline how important it is for insurers to work together to enhance the clarity, consistency and usability of their financial statements.



Implementation Challenge: IFRS for Oil & Gas and Utility Industries

The paper highlights both the leading themes and the specific issues that companies are grappling with as they use IFRS in the oil, gas and utility sector.



Accounting for change: A survey of banks' 2005 IFRS annual reports

The findings show just how much IFRS has affected the way banks report their results. The surveyed institutions are a representative global sample.



Real Time - IFRS in the mining sector

Real Time highlights some of the key areas of difficulty that impacts specifically on the mining industry under IFRS.

To order hard copies of these publications, email: global.ifrs.publications@uk.pwc.com

How PricewaterhouseCoopers can help

We can advise you on successful IFRS 7 implementation. To do this, we can draw on a broad range of professional skills in treasury, banking, technology and IFRS accounting. We offer solutions that integrate your business needs with an understanding of treasury strategy and advice on the evolving financial reporting standards and regulatory requirements.

For further information, please contact your regular PricewaterhouseCoopers representative or one of the following contacts to discuss how we can help you with your IFRS 7 issues:

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