CFA INSTITUTE | Centre for Financial Market Integrity

15 December 2008
Ms. Liz Figgie,
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: IASB Exposure Draft on Improving Disclosures about Financial Instruments: Proposed amendments to IFRS 7

Dear Ms. Figgie,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB's Exposure Draft, (ED*) Improving Disclosures about Financial Instruments: Proposed amendments to International Financial Reporting Standard Statement No.7* (IFRS 7).

The CFA Institute Centre represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics* and *Standards of Professional Conduct.*

EXECUTIVE SUMMARY

The disclosure of risk exposures and risk management effectiveness through financial statements is often inadequate[3]. IFRS 7 provided a useful initial guideline to improve disclosures about the risks posed by

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[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels, and London, CFA Institute is a global, not-for-profit professional association of more than 99,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom more than 86,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

[3] Membership surveys conducted over the last decade consistently show that our members believe there are significant quality gaps in the disclosures of risk management activities and risk exposure. The 2007 and 2003 corporate disclosure surveys showed quality gaps of -1.1 and -1.3 for risk management activities, respectively. The same surveys showed quality

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financial instruments. The ongoing credit crisis has accentuated the importance of financial instrument disclosures as a means of helping users to understand the risks associated with recognised and off-balance sheet items. Questions remain as to whether IFRS 7, with the proposed amendments, will yield a sufficiently robust and useful set of disclosures. In our response to the proposed amendments we:

- Echo the challenges expressed by various stakeholders regarding implementation of IFRS 7. We see the implementation and enforcement challenges as a necessary point of reference when thinking through the improvements required for IFRS 7.

- Encourage the board to provide an authoritative stamp by including under IFRS 7 the full set of disclosures recommended by the expert valuation advisory panel, as contained in the report issued on 31st October 2008 (EAP report).

- Support the enhancements, particularly the requirement of a three-level hierarchy of valuation. However, we believe that the disclosure of movement and roll-forwards should be required across all three levels.

- Encourage the adoption of a complete approach to disclosures of liquidity risk as opposed to one that only provides piecemeal enhancements. We identify key additional disclosures such as those related to off-balance sheet liquidity and credit risk contingent features. We also encourage the board to consider liquidity risk as a further motivation of using the direct method of reporting operating cash flows under the financial statement presentation project.

- Reiterate the need for disclosures identified as best practice in the EAP report and by the U.S. Securities and Exchange Commission (SEC). This includes enhanced disclosures around sensitivity analysis. We also encourage the disclosure of the fair value of investments in equity instruments without a quoted market price, and in contracts with discretionary participation features. The fact that such items are precluded from recognition on a fair value basis is an insufficient rationale to justify not requiring fair value disclosures.

GENERAL COMMENTS

Implementation Challenges

Paragraph 4 of the ED states that '*After IFRS 7 was applied in 2007, the board was informed that some of the disclosure requirements about the nature and extent of liquidity risk were unclear and difficult to apply and did not always result in useful information'*. While this paragraph flags liquidity risk difficulties, it also points to broader implementation problems experienced with IFRS 7 due to the interpretative burden posed[4].The implementation problem is further reflected in two recently published

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gaps in risk exposures of -1.0 and -1.3. These findings are part of a recurrent experience of poor quality disclosures, from the perspective of users.

[4] This is but one example of a broader problem with IFRS-inconsistent interpretation of standards and lack of an effective enforcement mechanism to ensure proper application of IFRS

reports[5] by PriceWaterhouseCoopers and Fitch Ratings. These reports highlight the variation in the implementation of IFRS 7 across selected financial institutions. Both of these reports find that while there has been some measure of improvement in risk disclosure, it is insufficient, and that an issue of poor comparability between firms remains. As noted by the Fitch report, *'The new disclosures are obvious improvements on prior disclosures but do not go far enough. Investors and analysts need better and more extensive disclosures around fair value measurements.'* Although it might be early in the adoption of IFRS 7, and corporate managers may subsequently enhance the levels of disclosure, it is clearly necessary for the IASB to refine IFRS 7 with a strong emphasis on implementation concerns. More importantly, many users of financial statements including investors (and, we assume, regulators of financial institutions) remain concerned with inconsistent implementation and the lack of enforcement of requirements. Comparability across financial institutions and companies as well as countries, continues to be seriously hampered by inconsistent and, at times, incoherent, implementation combined with the absence of consistent enforcement of required standards and disclosures.

Integration of Expert Advisory Panel recommendations

We welcome the proposed enhancements, particularly as they are likely to facilitate the ongoing convergence with U.S. GAAP. However, we would have expected the IASB, as a starting point, to incorporate all the incremental disclosure requirements proposed by the expert valuation advisory panel in the report issued on 31 October 2008 (EAP report). Convergence encapsulates the goals of both improvement and harmonisation. Where possible, and especially when there is clear need for improvements, IFRS should go beyond simply achieving parity with or marginal improvement to U.S. GAAP. We are surprised that the IASB has missed an opportunity to endorse the proposed incremental disclosures and possibly take a lead in initiating best practice disclosures. The IASB-adopted enhancements seem to be only partially responsive to information needs identified during the credit crisis, and it would be helpful to understand the basis for excluding other items the panel identified as important. We ask the IASB to consider requiring the disclosures proposed in the EAP report that have not been incorporated into the ED or at a minimum to recommend these as encouraged disclosures. Certainly, there are lessons to be learned from the history of how encouraged disclosures often only results in little more than boiler plate and meaningless information. Nevertheless, we are hopeful that in the current environment, auditors and regulators will persuade preparers to provide these disclosures.

We acknowledge that in the quest for enhanced disclosure, there is an inherent risk of data overload that could obscure useful information. In addition, preparers of financial statements argue frequently that additional disclosures cannot be assimilated, do not always reflect the way companies manage risks, or are not used. We counter that more accurate and useful information does not result in overload. Moreover, key attributes of any disclosures should be parsimony and transparency. The EAP report elucidates the key elements of disclosure including aggregation level and the criteria of inclusion (e.g., materiality of the instrument, uncertainty and subjectivity of reported values, the complexity of the instruments and reductions in liquidity). These identified dimensions would be consistent with what would be helpful for users.

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[5] *Accounting for Change: Transparency in the Midst of Turmoil- A Survey of Banks'* ,2007 annual reports August 2008- Price Waterhouse Coopers 2*) Fair Value Disclosures: A Reality Check*, June 26 2008, Fitch Ratings

Incorporate XBRL

Finally, we encourage the IASB to more effectively integrate XBRL into all of its standard setting activities. To this effect we recommend having an XBRL taxonomy incorporated into each exposure draft and thereafter each standard issued.

SPECIFIC COMMENTS

1. HIERARCHY OF VALUATION DISCLOSURES

We strongly support the proposal to have a hierarchical classification similar to that in FASB Statement No. 157, *Fair Value Measurements* (SFAS 157). The articulated user preference and voluntary adoption of the hierarchy by a number of preparers using IFRS is evidence that it is considered to be best practice. An added benefit of its implementation is that it will facilitate the convergence of financial instrument disclosures between U.S. GAAP and IFRS.

Movement across Hierarchy

In addition to the hierarchy, the ED requires the disclosure of movements into and out of the level 3 category. Given the backdrop of the credit crisis, it is understandable that there is a significant focus on disclosures and movements around the hard-to-value financial instruments category with unobservable inputs (i.e., level 3). Nevertheless, IFRS 7 ought to provide optimal disclosure across the spectrum of financial instruments by requiring the disclosure of movement across all 3 levels of the hierarchy. This particular requirement has been requested by different users (see Fitch Rating[6]). The Fitch Rating study found that an average of 67% of level 2 fair value assets and liabilities were in place for European institutions and 72% of the same for U.S. institutions, at fiscal year-end 2007. Given the material significance of level 2, it is of interest for users to understand movements in and out of the level 2 category.

Paragraph 27b (e) seems to allow the disclosure of movement across the levels and to require the reasons that necessitate reclassification. However, the current wording will likely result in minimal compliance as it only prescribes level 3 movements. The disclosure of only level 3 movements can be misleading because the economic performance of instruments held under that category can be offset through financial instruments categorised under the other two levels. For example, level 2 items can be used to hedge level 3 items. In addition, financial institutions sometimes hold financial instruments that have values bifurcated across the levels within the hierarchy.

[6] *Fair Value Disclosures: A reality check- Fitch Ratings*, June 26t 2008.

Disclosure of movement across all three levels would allow a more complete depiction of economic reality across the categories and the migration of financial instruments from one category to another is often a signal that the market for that class of instruments has deteriorated. Hence, users would benefit from seeing the complete and disaggregated picture (levels 1 and 2) along with level 3.

Significant Input

Paragraph 27 requires the disclosure of valuation techniques for which any significant input is not based on observable market data. It further stipulates that a significant input is an input that is significant to the fair value measurement in its entirety. We would like a more complete definition of significant input and propose that whether a particular input is significant should also be determined by the level of associated uncertainty. Management should assess associated uncertainty at the time of measurement and evaluate any expected deterioration or further increase in uncertainty. For example, where an exchange rate or interest rate is a significant input, this assessment would involve consideration of uncertainty or risk implied by futures or forward rates. The implied futures rates will reflect the market expectations of the underlying risk factor and when this is compared to its current, observable levels, it can help convey the uncertainty associated with the particular risk factor.

Additional Hierarchy Disclosures

In previous comment letters[7] we have proposed the disclosure about hedge effectiveness and asset/liability management effectiveness of matched items residing in different valuation hierarchies. One of the features of the current credit cycle is that hedging strategies have often proved to be ineffective and financial statement users need to understand when that is the case.

2. LIQUIDITY RISK DISCLOSURES

We concur that there is a need to provide incremental information about the liquidity risk of financial instruments. Liquidity risk is a salient feature of the current credit crisis and it is appropriate to focus on providing information that will help users to understand how well managers are handling such risk. For starters, the current definition of liquidity risk needs to be improved.

A cogent and complete understanding of how managers conduct their asset and liability management assessment would be a preferable starting point to delineate liquidity management requirements, in contrast to the seemingly piecemeal refinement currently being applied. The November 2008 *Financial Reporting Council (FRC) consultation (an update for directors of listed companies on going concerns and liquidity risk)* lays out some of the challenges associated with disclosures of liquidity risk including the dispersion of liquidity information in the annual reports. We encourage the integration and centralisation of liquidity risk information. We also encourage the IASB to consider liquidity risk as a further motivation for using the direct method of reporting operating cash flows under the financial

[7] Comment letter on Reducing Complexity for Financial Instruments and 2) Comment letter on SFAS 157-d clarification

statement presentation project. This is because disaggregated operating cash flows can help portray to users the cash generating capacity of a reporting enterprise and this has a bearing on liquidity.

Maturity Analysis

To convey liquidity management effectiveness, the ED proposes the disclosure of a) the remaining contractual or expected maturity of non-derivative financial liabilities, and b) a maturity analysis of derivative financial liabilities. Aside from it being just one potential indicator of liquidity management, there are two inherent limitations to the application of maturity as a measure of interest rate risk of financial instruments:[8]

- The value of many financial instruments are attributable in part or even predominantly to cash flows prior to maturity; and
- Many financial instruments accrue interest using a floating interest rate, which reduces or even eliminates interest rate risk, regardless of maturity.

A more appropriate means for assessing asset and liability management effectiveness is the illustration and disclosure of duration analysis.

Liquidity Risk of Derivative Assets

The focus on liquidity risk of derivative financial liabilities overlooks the fact that derivative financial assets often turn into liabilities and vice versa. Hence it will be more meaningful to disclose liquidity risk associated with both derivative assets and liabilities.

Additional Liquidity Disclosures

We also recommend that the ED be expanded to require a further set of necessary liquidity risk disclosures as follows:

- The funding risk that arises because of off-balance sheet items. This would be similar to the information contained in the commitments and contingencies schedule under U.S. GAAP.
- Credit risk contingent features of derivative instruments. Changes in market values can result in the need for the instrument bearers to post additional margin and therefore could present significant and potentially unanticipated liquidity requirements. This disclosure is currently required under the soon to be effective standards on derivative disclosures in FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* [9].

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[8] Ryan.G.Stephen, 2007, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, Second Edition, John Wiley and Sons

[9] FAS161–14 Provides the below example illustrating the credit risk related contingent features: **Example 3: Disclosure of Contingent Features in Derivative Instruments:**

3. OTHER DISCLOSURES

Paragraph 29 lists the financial instruments for which fair value disclosures are not required. These include investments in equity instruments without a quoted market price, and contracts with discretionary participation features. Paragraph 30 proposes several accompanying disclosures to help users understand why the determination of fair value is difficult. However, there is a conceptual inconsistency when requiring management's internal estimates of fair value are required for some financial instruments that are hard to value, yet necessitating the use of cost or carrying value is permitted for other financial instruments. The question of disclosures for such instruments is separate from recognition and measurement. Encouraging disclosures as an initial step can facilitate subsequent recognition. It is not clear to us why management is unable to use a level 3 approach to measure the fair value of investments in this class of equity instruments and contracts with discretionary participation features. Did management not use a valuation methodology at the time of the initial investment in these securities? Why should we not ask or expect management to disclose the change in circumstances that has rendered useless or unreliable its initial valuation model?

In conclusion, we reiterate the need to include some of the key recommended disclosures contained in the EAP report. We also enclose an attachment showing a list of best practice disclosures identified by the SEC. We encourage the board to use this and the EAP report as a basis of identifying incremental useful disclosures. Examples of such useful disclosures include:

Sensitivity Analysis

Sensitivity analysis is crucial to conveying the range of outcomes possible. Consideration should be given to the nature and extent of sensitivity analysis that is relevant to users. We believe that investors are best served when managers provide sufficient information about the estimation model or process and the key inputs and assumptions so that investors can judge the reasonableness of the assumptions and ranges and compare them with the assumptions and ranges used in similar circumstances by other firms. In addition, it is helpful to know how management uses sensitivity analysis in its risk management process and which assumptions are central to a firm's largest risks.

Some useful considerations to improving sensitivity analysis include:

- Separating forward-looking and retrospective sensitivity analysis.
- Providing symmetrical risk analysis; investors are interested in knowing both the up-side and down-side potential of the assets and liabilities held.

Contingent features
Certain of the Company's derivative instruments contain provisions that require the Company's debt to maintain an investment grade credit rating from each of the major credit rating agencies. If the Company's debt were to fall below investment grade, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position on December 31, 2009, is $XX million for which the Company has posted collateral of $X million in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered on December 31, 2009, the Company would be required to post an additional $XX million of collateral to its counterparties.

- Disclosing multifactor risk analysis, because it is more informative than a single factor sensitivity analysis. This is especially the case due to the correlation of key risk factors (e.g., liquidity risk and counterparty credit risk).
- Balancing the level of aggregation in sensitivity analyses. Too much aggregation could offset countervailing risk factor effects, yet highly disaggregated sensitivity could provide information overload to investors.

Valuation Methodologies

We believe that disclosure of valuation methodologies is important because it informs investors about the uncertainty of inputs to and outputs from valuation models. Valuation methodology disclosure should include information about:

- Model limitation disclosures;
- Valuation forecast error (i.e. differences between the internal model valuation and the exchange value realised); and
- Effect of credit risk deterioration and the credit value adjustments.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org, or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at patrick.finnegan@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director

/s/ Gerald I. White

Gerald I. White, CFA
Chair,
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council