CFA INSTITUTE: ISSUE BRIEF

INVESTORS CALL FOR THE ENHANCEMENT OF FINANCIAL INSTRUMENTS RISK DISCLOSURES IN NEWLY ISSUED REPORT

CFA Institute issues report calling for enhancement of existing financial instruments risk disclosures.

OVERVIEW

CFA Institute has issued Volume 1 of a two-part report on financial instruments risk disclosures. Volume 1 provides a user perspective on financial instrument credit, liquidity and market risk disclosures. Volume 2, to be issued at a later date, will provide a user perspective on disclosures of derivatives and hedging activities. Volume 1 can be accessed at **www.cfainstitute.org/learning/products/publications**.

The risk disclosures evaluated relate to International Financial Reporting Standards Statement No.7 *Financial Instruments: Disclosures* (IFRS 7).

The quote shown opposite reflects the overall evaluation of these disclosures.

To improve the usefulness of disclosures to investors, the CFA Institute report recommends several changes including: greater integration of related risk disclosures, more informative qualitative disclosures and the presentation of executive summaries for key risk categories. In addition, preparers need a paradigm shift towards primarily communicating on a holistic basis about their risk exposures and risk management, rather than aiming to merely comply with accounting standards requirements.

" IFRS 7 has brought a great amount of useful additional information compared to earlier financial statements disclosures. However, I am concerned about the discrepancy of what is required by the standard and what is actually reported. Secondly, there may, in certain instances, be issues around the quality of the information that is disclosed. I am not sure how carefully such information has been audited. Often significant underlying assumptions and methodologies are not disclosed.

With some corporations the wording of the disclosures is very generic, without adding a lot of informational value. It may well be that not all risk disclosures are equally applicable for all corporations, but the focus should rather be on delivering crucial information that adds value to financial statement users as opposed to mere compliance."

– Analyst Respondent

To find out more please visit **www.cfainstitute.org**

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WHY THE QUALITY OF FINANCIAL INSTRUMENTS RISK DISCLOSURES MATTERS

The importance of financial instrument risk disclosures as a means of helping investors to understand the risks associated with on- and off-balance sheet items has been accentuated during both the on-going sovereign debt crisis and the 2007-09 market crisis. As illustrated in **Figure 1**, these crises have highlighted the interconnectedness which exists between the state of the economy and several key financial risk exposures such as credit, liquidity and market risk. At the same time, there is often limited transparency for users regarding these risk exposures and how they are managed by reporting entities. The limited transparency regarding these risk exposures contributes to mispricing of risk, misallocation of capital and abates investors' ability to provide market discipline on a timely basis. This limited transparency also contributes to the disorderly capital market correction in the valuation of companies during crisis periods.

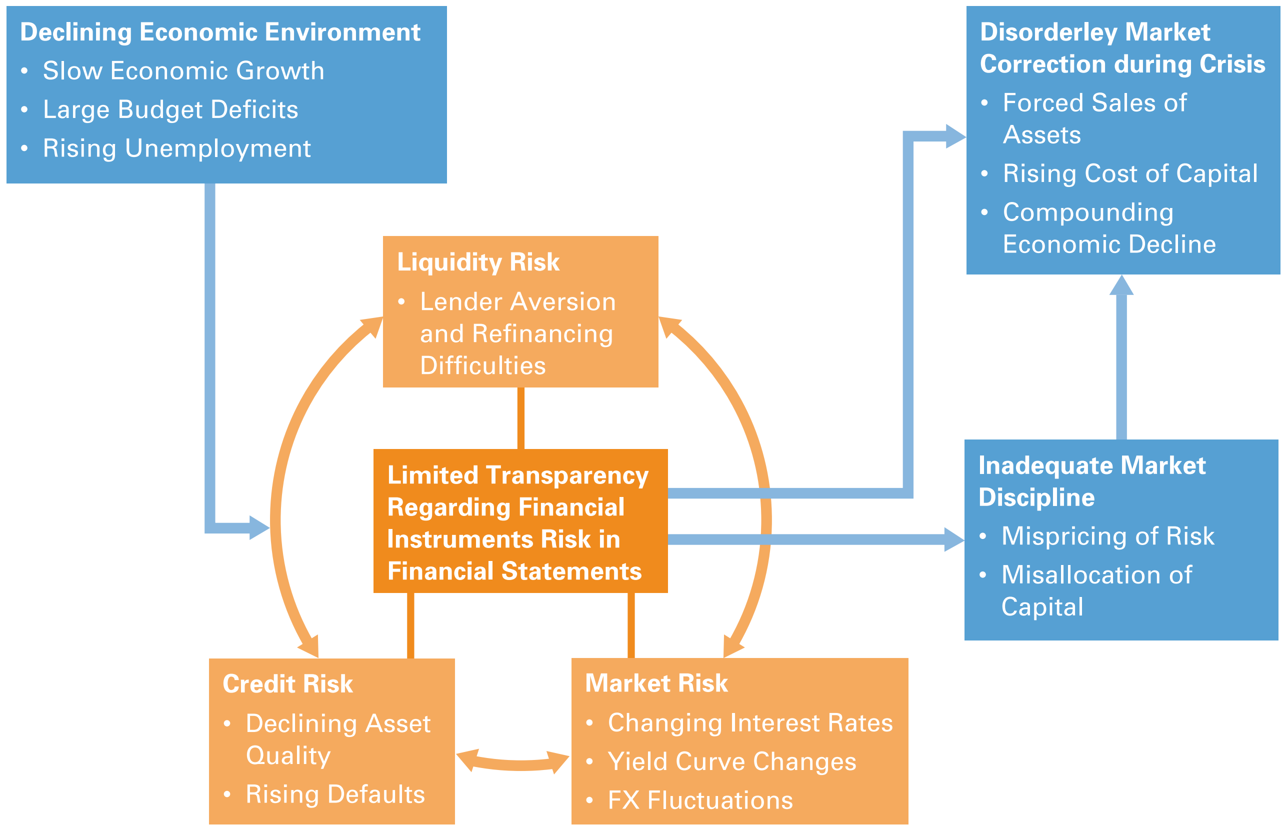
In a broader sense, across the full economic cycle, high quality financial instrument risk disclosures can assist in informing users regarding:

- Financial instrument measurement uncertainty, including the sensitivity of reported values to inputs and assumptions, and the explanation of period-to-period movements; and
- Forward-looking financial risk information that has a bearing on entity-wide risk. Risk disclosures have the potential to inform investors regarding a reporting entity's risk profile regardless of the measurement basis (i.e. fair value or amortised cost) applied.

Given the general imperative of improving risk disclosures as evident from the market crises, a study that contributes to the dialogue on how to improve the quality of financial instruments risk, is appropriate and timely. The need to improve risk disclosures based on the input from investors and other key stakeholders was noted by the Financial Stability Board (FSB) in a recently issued report:

> "While standard setting bodies have improved their disclosure requirements since 2008, the Financial Stability Forum (FSF) had also recommended that investors, financial institutions and auditors should jointly develop risk disclosure principles and should work together to identify enhancements in specific risk disclosures that would be most relevant given the recent evolution of market conditions. This has not happened."
>
> – Financial Stability Board

FIGURE 1: CONSEQUENCES OF LIMITED TRANSPARENCY REGARDING FINANCIAL INSTRUMENTS RISK EXPOSURE



CFA STUDY ANALYTICAL APPROACH

In its approach, the CFA Institute study: 1) evaluates the findings of various pieces of literature and their conclusions regarding the usefulness of risk disclosures; 2) obtains, through user surveys and interviews, feedback regarding the importance of, satisfaction with, application and usefulness of current financial risk disclosures; and 3) reviews risk disclosures of financial and non-financial institutions so as to place in context the user feedback obtained. The study triangulates these sources of information in order to analyse and convey user perspectives on IFRS 7 disclosures.

KEY FINDINGS

The study's findings show that risk disclosures are both widely used and regarded as important by users. However, users have a low level of satisfaction with these disclosures. The user feedback and company analysis helps to explain the low satisfaction, showing the following general shortcomings of risk disclosures:

- Risk disclosures are difficult to understand. This is due to their incomplete nature and often fragmentary presentation;
- Market risk category is too broad;
- Qualitative disclosures provided are uninformative;
- Users have low confidence in reliability of quantitative disclosures ;
- There is low consistency and comparability of disclosures. As illustrated in **Table 1** below, which reflects the disclosure quality index for four banking institutions, there are inconsistencies in the quality of disclosures even for firms within the same sector and business model; and
- Top-down and integrated messaging on overall risk management is missing.

RECOMMENDATIONS TO ENHANCE DISCLOSURES

Based upon the noted deficiencies, the report's general recommendations are as follows:

- **Executive Summary of Risk Disclosures Required**
  An executive summary of risk disclosures should be provided outlining details of entity-wide risk exposure and effectiveness of risk management mechanisms across different risk types. The executive summary should be provided for risk types considered to be significant for specific business models.
- **Differentiate Market Risk Categories**
  The components of market risk should be differentiated into more specific categories (i.e. interest rate, foreign currency and commodity). These proposed new categories should be treated with the same level of distinctiveness for reporting purposes as is the case with credit and liquidity risk under IFRS 7.
- **Improved Alignment of Qualitative and Quantitative Disclosures**
  Qualitative disclosures should better explain quantitative measurements.
- **Standardisation and Assurance of Quantitative Disclosures**
  Standardised and adequately audited quantitative disclosures are required to improve comparability.
- **Improved and Integrated Presentation of Disclosures**
  Integrated, centralised and tabular risk disclosures should be provided. For example, there should be integration of risk exposure and risk management information.

Address Areas for Improvement of Specific Risk Disclosures

In addition, the study recommends specific improvements on credit, liquidity and market risk are required. Key common areas for improvement across the credit, liquidity and market risk categories include the need to provide: a) informative entity-specific qualitative disclosures; b) improved and more meaningful sensitivity analysis; c) meaningful disaggregation of counterparty details to convey concentration risk; and d) risk information related to off-balance sheet exposures.

Focus on Communication of Key Information and Not Mere Compliance

Overall, as elucidated in the study, the reporting outcomes from IFRS 7 disclosure requirements illustrate that a 'principles-based' definition of disclosure is not the antidote to fears about boilerplate and uninformative disclosures. In fact, broad and vague definitions that are then described as principles could be in many cases a significant contributory factor to uninformative disclosures. The review of these financial risk disclosures shows that there remains a need for financial statement preparers to shift away from mere 'tick-the-box' compliance with disclosure requirements. Preparers should adopt a 'meaningful communication mindset' aiming to convey risk exposures and risk management policy effectiveness, as well as to foster a dialogue with investors. Such a paradigm shift is necessary before a 'principles-based' disclosure approach can result in substantially useful information.

TABLE 1: DISCLOSURE QUALITY INDEX (DQI) – BANKING FINANCIAL INSTITUTIONS

Company	Credit Risk	Liquidity Risk	Market Risk
Number of Dimensions in Index	13	12	11
Banking Financial Institution 1	92%	71%	59%
Banking Financial Institution 2	88%	71%	27%
Banking Financial Institution 3	100%	79%	59%
Banking Financial Institution 4	92%	75%	91%

RECOMMENDATIONS TO ENHANCE DISCLOSURES

Enhancement of Quality Should be Overarching Focus of Disclosure Reform

A commonly cited argument against providing more information through disclosures tends to be that companies are already providing voluminous disclosures and that these disclosures are burdensome for users to read. Accordingly, reducing disclosure volumes could be considered by some stakeholders, as being what ought to be the focal point of disclosure reform. Users would likely concur that it is worthwhile to eliminate boilerplate information from disclosures (e.g. when companies either merely restate respective IFRS standards' requirements or provide generic descriptions of risk management). However, the overarching focus of improving disclosures should be on defining and implementing principles that enhance both the information content and understandability of disclosures. What investors seek is relevant, complete and parsimoniously presented information. Such type of information will be useful and not burdensome for investors. The need to focus on quality of information was pinpointed in the quote below from an ACCA study[1] on narrative reporting.

In this vein, the CFA Institute report has outlined general and specific recommendations of improving risk disclosures. If implemented, these recommendations will result in risk disclosures that are both more informative and easier to for investors to process for security valuation and analysis purposes.

[1] Campbell, D. and Slack, R. (2007), *Narrative Reporting-Analysts' Perceptions of its Value and Relevance,* ACCA Monograph-Research Report 104.

> "This is where banks sometimes get confused, because you ask for better disclosure and they think 'oh look, we've given you 600 pages already' which contains 575 pages of completely worthless guff. What we really want is granularity and this is in the areas that matter."
>
> – Analyst Respondent

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