



## Accounting alert 2008/05

### Are you ready for AASB 7?

The June reporting season is just around the corner. One of the major new accounting requirements for this reporting season is AASB 7 *Financial Instruments: Disclosures*, which applies to June year-ends for the first time.

There are numerous commercial and interpretative issues in applying AASB 7 and the current global volatility in credit and other financial markets presents additional challenges.

In this Accounting alert, we summarise some of the key practical, commercial and technical considerations in applying AASB 7. The key matters covered below are as follows:

- **practical considerations** – a short checklist of points for boards and senior management to consider in assessing their preparedness for AASB 7
- **example detailed issues** – technical, interpretative and commercial issues that entities might face in applying AASB 7
- **more information and other resources.**

A brief recap of the requirements of AASB 7, including an overview of the major new and revised requirements of the Standard, can be found in the Appendix.

We have also released a Deloitte Australian Insights podcast where Darryn Rundell, one of Deloitte's Accounting Technical Partners, talks with Richard Hayes, Senior Manager – Financial Reporting Global Markets at ANZ, about the challenges and practical considerations of adopting AASB 7 *Financial Instruments: Disclosures*. This podcast can be accessed on our website via [www.deloitte.com/au/podcasts](http://www.deloitte.com/au/podcasts).

Example AASB 7 disclosures can also be found in our **illustrative financial reports**, which are also available on our website.

#### Practical considerations

The table that follows is not exhaustive, but instead highlights some of the practical considerations that entities might face in applying AASB 7. The topics below are likely to apply to the majority of entities preparing to apply AASB 7, presented as a short checklist of points for boards and senior management to consider in assessing their preparedness for AASB 7 and its impacts.

Topic	Considered
<b>Corporate governance</b>	
<p><b>The disclosures present a corporate governance challenge</b> – AASB 7 focuses on both qualitative and quantitative disclosure based on internally reported information – readers of the financial statements will expect information about how entities identify and respond to risks, and how they ensure that appropriate risk management policies and procedures are in place. New risks, or risks that are managed in a different way to established formal policies, may emerge from the process of preparing the AASB 7 disclosures. Boards of directors and management need to ensure that they have developed, documented and implemented risk management objectives and strategies that are appropriate for their operations and exposures. This issue is further amplified by the fact that disclosure is required of changes in these policies compared to the comparative period.</p>	<input type="checkbox"/>
<p><b>There is heightened risk aversion in the current market</b> – in light of the current focus on credit quality, exposure to financial and other risks, enhanced caution in how the disclosures are presented in the financial statements is warranted. Entities need to ensure that the disclosures are comprehensive and informative and present an accurate picture of an entity's financial instruments – voluntary disclosure of additional information may be necessary. Disclosures that may require particular attention include the liquidity analysis, market risks that are unhedged or managed with complex derivatives with features such as knock-in or knock-out clauses or with unusual terms. Care also needs to be taken that sufficient explanation is provided where risks are internally managed in a different way in which disclosures are made under AASB 7, e.g. the liquidity disclosures are presented on an undiscounted and aggregated approach, but this may not be how the organisation manages its liquidity risk.</p>	<input type="checkbox"/>
<p><b>The disclosures are likely to be closely scrutinised</b> – market conditions combined with new disclosure requirements mean that AASB 7 disclosures are likely to be closely scrutinised by regulators, auditors and others. In addition, entities can expect attention from shareholders, financiers, insurers and other market participants (including possible predators, hedge funds, short sellers and the like) as the disclosures will be an excellent source of information on any entity's financial risk exposures and how they are managed.</p>	<input type="checkbox"/>
<p><b>Benchmarking of disclosures</b> – to avoid negative market reaction, it is important that entities disclose information that is useful and comparable to others in their industry and to their peer groups. This will also necessitate finding the 'right balance' between too much and too little disclosure. The benchmarking exercise should extend beyond the format and layout of the disclosures to also focus on the way in which risks are managed, e.g. an entity that hedges against interest rate or market price risk has a different risk profile to one that doesn't.</p>	<input type="checkbox"/>
<p><b>Look for opportunities</b> – applying AASB 7 affords an excellent opportunity to reassess the manner in which risks are identified and managed within the organisation. The disclosures made also permit entities to present more information about the way risk is managed, with the qualitative disclosures particularly enabling entities to showcase their risk management strategy, e.g. using 'economic hedges' that do not qualify as 'accounting hedges', or highlighting exposures to particular types of risks where market participants may be looking for such exposure (unhedged commodity price risks, etc.).</p>	<input type="checkbox"/>
<b>Systems and procedures</b>	
<p><b>Ensure knowledgeable personnel prepare the disclosures</b> – financial instruments, risk and accompanying exposures are a complex and wide-ranging challenge in many organisations. Developing the appropriate systems and disclosures will require a holistic approach, involving specialist knowledge that may be widely dispersed in the organisation, such as treasury and risk management personnel, financial accountants in divisions, subsidiaries and offshore operations as well as senior management and the board of directors. Therefore, leaving the preparation of the disclosures to one department may risk draft disclosures that are inappropriate, incomplete or inaccurate. The need for expert advice should also be considered, particularly in matters of interpretation or where complex calculations are required to derive fair values, undiscounted cash flow analyses and so on.</p>	<input type="checkbox"/>
<p><b>AASB 7 is more than just disclosure</b> – a number of the mandatory disclosures necessitate sometimes complex calculations, judgement and information gathering. Many small (and not so small) entities may not necessarily have systems from which all the required disclosures can be obtained. In addition, information provided by counterparties such as banks and other financial institutions is unlikely to be sufficient to meet the extensive disclosures required by AASB 7 – particularly in relation to sensitivity and liquidity analyses.</p>	<input type="checkbox"/>
<p><b>One size does not fit all</b> – the significance of an entity's financial instruments and the nature and extent of risks arising from those financial instruments will vary from industry to industry and from entity to entity. This means that disclosures made will need to be tailored to the unique circumstances of each entity. Model financial statements are a useful guide but not a panacea in developing the disclosures.</p>	<input type="checkbox"/>
<p><b>A lot of information must be collated</b> – many of the AASB 7 disclosures require a lot of detailed information gathering and analysis, which can be time-consuming and laborious, e.g. undiscounted information for the liquidity disclosures, collating information on past due but not impaired receivables, etc. The preparation of the disclosures must allow sufficient time for this information to be obtained.</p>	<input type="checkbox"/>

Topic	Considered
<b>Other considerations</b>	
<b>Disclosures from prior years may not be a good starting point</b> – prior to the mandatory application of AASB 7, entities were required to provide disclosure about financial instruments under AASB 132 <i>Financial Instruments: Presentation and Disclosure</i> and AASB 130 <i>Disclosures in the Financial Statements of Banks and Similar Financial Institutions</i> . However, these disclosures were often high-level, lacking in detail and prone to ‘boiler plate’ disclosure. In addition, AASB 7 introduces a lot of emphasis on qualitative disclosure which was not necessarily required under the superseded Standards. Accordingly, an entity’s disclosures from previous periods are unlikely to be sufficient for AASB 7 purposes.	<input type="checkbox"/>
<b>A lot of judgement is required</b> – AASB 7 is a ‘principles based standard’ that offers broad parameters and limited guidance, leaving the detailed application to individual entities. There are a vast array of interpretative issues upon which the board and management need to decide – from simple decisions like the level of aggregation and time bands disclosed, to complex issues about how to interpret the requirements around the various quantitative and qualitative disclosures (some of which are covered below).	<input type="checkbox"/>
<b>Parent entity and comparative disclosures are required</b> – the disclosures given are required for both the consolidated and parent entity financial statements and there is no exemption from the requirement to provide comparative information. Obtaining the necessary information can be a time-consuming task, particularly where systems were not previously designed to capture such information automatically, e.g. past-due amounts on receivables, undiscounted liquidity information. Also, the disclosures for the parent are likely to be quite different to the consolidated disclosures as the nature of risks are often different, e.g. the parent may not have any operations other than acting as an investor, and sometimes a financier, to its subsidiaries.	<input type="checkbox"/>
<b>Don’t forget capital disclosures</b> – consequential amendments to AASB 101 <i>Presentation of Financial Statements</i> introduce new qualitative and quantitative disclosure requirements around how an entity manages its capital.	<input type="checkbox"/>

### Example detailed issues

The table that follows is not intended to be exhaustive, but instead is designed to highlight some of the technical, interpretative and commercial issues that entities might face in applying AASB 7 at the detailed level. The issues that arise are often entity specific, so not all the issues listed below will be applicable in all cases and additional issues may arise. However, the list serves as an illustration of the types and complexity of issues that can arise in complying with AASB 7.

Topic	Considered
<b>Credit risk</b>	
<b>Cash loss or loss to income statement</b> – entities need to decide whether credit risk disclosures are presented on a ‘cash loss’ (face value) or ‘loss to income statement’ basis, make an accounting policy choice and apply it consistently.	<input type="checkbox"/>
<b>Non-trade receivables</b> – the disclosures required extend to all types of receivables, including those from derivative transactions, cash and cash equivalents at banks, as well as other classes of receivables from associates, related parties and similar entities. Objectives, policies and procedures for these receivables may be different, and perhaps not as robust, as for trade receivables.	<input type="checkbox"/>
<b>Past due amounts</b> – AASB 7 requires disclosure of amounts that are past due but not impaired. Where a significant portion of a receivable amount is identified as past due, it may indicate to debtors and others that the stated credit period is not strictly enforced, with potential cash flow implications.	<input type="checkbox"/>
<b>Renegotiated financial assets</b> – disclosure is required about amounts that would otherwise be past due or impaired had they not been renegotiated, revealing information that many entities may consider commercially sensitive, or requiring the collation of information that is not readily obtainable from existing systems.	<input type="checkbox"/>
<b>Market risk</b>	
<b>Foreign currency risks</b> – there is uncertainty on how groups with many different functional currencies should disclose foreign currency risks, e.g. exposures between different functional currencies, indirect exposures through foreign operations, etc. In addition, information may be difficult to obtain from foreign operations, particularly in large diversified groups with operations in many geographic areas. In particular, details of exposure to foreign currencies by subsidiaries may be hidden on conversion into the functional currency of those subsidiaries.	<input type="checkbox"/>
<b>Sensitivity analysis</b> – there is a significant amount of judgement on what ranges should be disclosed (e.g. 1%, 2%, 10%, etc), whether various risks should be disaggregated (e.g. all foreign currencies exposures moving together or the impact of each significant foreign currency exposure) and so on. Many entities may choose to avoid a ‘value at risk’ approach in favour of a more simple approach, however this may not provide information that is as reliable. This is one area where industry and peer group benchmarking will be particularly important.	<input type="checkbox"/>

Topic	Considered
<p><b>Other market risks</b> – market risks comprise currency risk, interest rate risk and other price risks. Identifying and quantifying other price risks that an entity is exposed to can be a difficult and time consuming task and may reveal risks for which formal and thorough risk management policies have not been fully developed.</p>	<input type="checkbox"/>
<p><b>Multiple variables and variability in response to variables</b> – some financial instruments may be sensitive to more than one variable, such as options which are sensitive to both the spot rate as well as volatilities between currencies. Similarly, equity price risk sensitivities may need to recognise both changes in the share market index and the different beta values of individual securities in that index. Without an appropriate valuation model, developing sensitivity analyses in situations such as these can be challenging.</p>	<input type="checkbox"/>
<p><b>Liquidity risk</b></p>	
<p><b>Scope exemptions</b> – AASB 7 does not apply to all financial instruments, but some of these may have significant impacts on future profitability, e.g. earn-outs and other contingent payments under business combinations, certain derivatives over own shares, etc. Consideration should be given to additional disclosure where considered appropriate.</p>	<input type="checkbox"/>
<p><b>Financial liabilities only</b> – because AASB 7 focuses on financial liabilities, the liquidity risk analysis (usually presented as a table) will present only outflows, e.g. out-of-the-money derivatives must be shown but in-the-money derivatives do not. Entities may wish to include financial assets in the table as well to ‘balance’ the liability disclosure.</p>	<input type="checkbox"/>
<p><b>Undiscounted basis</b> – disclosures about liquidity risk are required on an undiscounted basis, which can be difficult to determine for derivatives and complex financial instruments, or alternatively may require complex calculations, extensive judgement and assumptions and/or substantial information gathering. These disclosures are made more challenging where the fair value of derivatives is supplied by third parties and the entity does not have access to the underlying calculation models used by the third party.</p>	<input type="checkbox"/>
<p><b>Hedging</b> – AASB 7 requires hedging instruments to be included in the liquidity risk table, but the hedged item may be a non-financial item that is not included in the table. This risks presenting information that may be misinterpreted by users without additional explanation.</p>	<input type="checkbox"/>
<p><b>Gross vs. net</b> – there are ongoing debates globally about whether particular types of financial instruments can be shown gross or net in the liquidity analysis. For example, the pay leg of a cross currency swap would be included in the liquidity analysis, effectively resulting in a ‘doubling counting’ of the cash flows associated with the underlying debt.</p>	<input type="checkbox"/>
<p><b>Off balance sheet items</b> – the disclosures made must include unrecognised financial instruments such as loan commitments – many of these will be ‘at call’ and so shown in the shortest time band disclosed. Additional disclosure and information may be necessary to fully explain the apparent cash flow implications of these types of instruments.</p>	<input type="checkbox"/>
<p><b>Amounts not fixed or determinable</b> – a lot of judgement can be involved in determining the amounts to disclose in relation to instruments that do not have fixed or determinable amounts, e.g. some derivatives, financial guarantees, loan commitments, etc.</p>	<input type="checkbox"/>
<p><b>Impacts of loan covenants on liquidity</b> – AASB 7 only specifically requires disclosure of breaches however if loan covenants are critical to managing liquidity risk then disclosure should be considered, particularly where a breach might fundamentally change the contractual liquidity analysis provided. Furthermore, where long-term borrowings are considered to form part of the ‘capital’ of an entity, it may also be necessary for loan covenants to be disclosed under AASB 101.</p>	<input type="checkbox"/>

### More information and other resources

Our **Financial instruments advisory services** experts have extensive experience in assisting companies implement AASB 7 in a practical and commercial way – having already provided assistance to many major Australian corporates and being linked into our network of IFRS professionals around the globe. You can find out more about how Deloitte can assist in the AASB 7 transition and implementation process through your local Deloitte contact, on our website at [www.deloitte.com.au](http://www.deloitte.com.au), or by contacting any of the following people:

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In addition, the following resources are available on our websites, [www.deloitte.com.au](http://www.deloitte.com.au) or [www.iasplus.com](http://www.iasplus.com)

- Illustrative financial reports
- Accounting alert 2005/11 'International Accounting Standards Board releases IFRS 7 *Financial Instruments: Disclosures*'
- IAS Plus Newsletter 'IFRS 7 *Financial Instruments: Disclosures*' (IAS Plus website)
- IFRS-related tools and resources.



**Appendix – Recap of the requirements of AASB 7**

AASB 7 was issued by the AASB in August 2005 and is equivalent to IFRS 7 *Financial Instruments: Disclosures*. The standard applies to annual reporting periods beginning on or after 1 January 2007 and must be applied by reporting entities reporting under the *Corporations Act 2001* and to general purpose financial reports of other reporting entities.

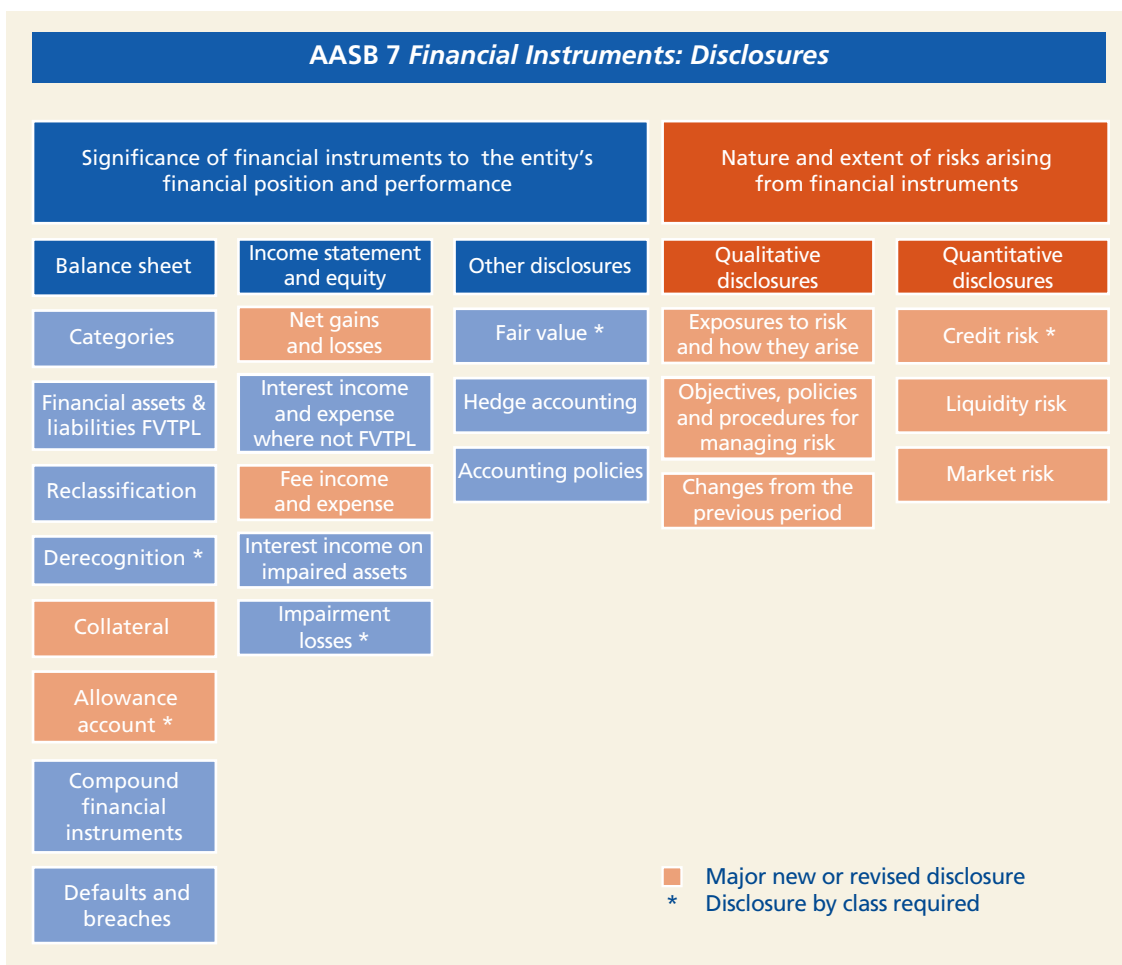
AASB 7 deals with the disclosure requirements in relation to all risks arising from financial instruments (with limited exemptions), and applies to any entity that holds financial instruments. The level of disclosure required depends on the extent of the entity's use of financial instruments and its exposure to financial risk.

The objective of the Standard is to require entities to provide disclosures that enable users to evaluate the significance of an entity's financial instruments and the nature and extent of risks arising from financial instruments and how the entity manages those risks.

To meet this objective, the Standard requires that an entity disclose both quantitative and qualitative disclosures about financial instruments and risks.

The Standard carries forward many of the disclosure requirements previously within AASB 132 *Financial Instruments: Disclosure and Presentation* and AASB 130 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. However, there have been some editorial changes from the requirements of those Standards as well as additional disclosure requirements added.

The diagram below summarises the requirements of AASB 7, highlighting the major new and revised requirements:



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