Grant Thornton

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Technical Accounting Alert

AASB 7 Financial Instruments: Disclosures

This Alert sets out the key changes and actions entities will need to put in place in order to comply with the requirements of AASB 7.

Which entities have to comply with this accounting standard?

AASB 7 is applicable to:

- All entities who are required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and which are reporting entities;
- All other reporting entities preparing general purpose financial reports; and
- Financial reports that are held out to be general purpose financial reports.

Remember this is a disclosure standard only and therefore non-reporting entities may opt out of the requirements of this standard.

What is the application date for AASB 7?

The application date for this standard is financial years beginning on or after 1 January 2007. However comparative information is required.

Year End	Application Period	Comparative Period
31 December	31/12/2007	31/12/2006
31 March	31/3/2008	31/3/2007
30 June	30/6/2008	30/6/2007
30 September	30/9/2008	30/9/2007

What is the purpose of AASB 7?

AASB 7 prescribes both qualitative and quantitative disclosures relating to financial instruments in order to increase:

- The comparability of the financial statements; and
- The level of detail in an entity's balance sheet and income statement.

Do we need another financial instrument accounting standard?

Whilst this is the fourth accounting standard relating to financial instruments that has been issued under the AIFRS regime, AASB 7 replaces some requirements in AASB 132 Financial Instruments: Presentation and Disclosure (now renamed AASB 132: Presentation) and supersedes AASB 130 Disclosures in the Financial Statements of Bank and Similar Institutions.

There are no changes in the requirements of AASB 139 Financial Instruments: Recognition & Measurement resulting from the application of AASB 7.

What are the key considerations?

The introduction of AASB 7 presents many organisations with significant challenges, stemming largely from the changed focus of financial instrument disclosures and the sheer volume of them. AASB 7 disclosures are required to be presented from management's perspective, or in a manner representative of how management monitor and manage financial instrument risk. The majority of AASB 7 disclosures relate to factors external to the trial balance; i.e. not driven by the numbers in the general ledger.

There may be as many as 70 additional disclosures relating to financial instruments required under AASB 7. Many of the additional disclosures will even apply to those entities with non-complex financial instruments.

Some of the key new disclosures are that an entity shall:

- Disclose how a reasonable movement in market conditions, such as interest or exchange rates, would have affected the entity's year end results;
  - this disclosure is considered to be one of the most challenging aspects of AASB 7, as it is a new requirement, and calculating relevant sensitivity analysis may be complex;
  - The format of this disclosure has not been prescribed, however much guidance is offered within AASB 7 regarding how to best present this analysis. As this analysis is beyond anything previously required by AASB 130 or AASB 132, considerable difficulties are anticipated for entity's without sophisticated risk management systems.
- Acknowledge and disclose the information used by key management when measuring and managing risks associated with financial instruments.

Appendix 1 contains a brief summary of the disclosure requirements to assist when considering the impact of AASB 7 on your entity.

Further detail of each significant disclosure is provided below:

Considerations for management

As noted, AASB 7 disclosures are to be presented in the same form as those used to monitor internal performance and there is much for management to consider. Such considerations include:

- Whether financial instrument risks (both new and existing) are identified and managed in the most effective manner. The process of compiling the AASB 7 information, may afford entities an excellent opportunity to review these processes, and make changes were appropriate.
- Whether the entity's current system has the capability to collect and compute complex calculations to assist with judgements.
- The compilation of AASB 7 disclosures will be time consuming and sufficient time should be allowed. Consideration should also be given whether the current management team have the appropriate skills, knowledge and capacity to complete the disclosure or whether additional resources or specialists consultants may be required.
- Entities face a diverse range of financial instrument risks and while example disclosures may prove beneficial they cannot be adopted with a "one size fits all" mindset, and should be tailored as appropriate.

Qualitative Disclosures

For each type of risk resulting from a financial instrument (e.g. credit risk, foreign exchange rate risk, interest rate risk) AASB 7 requires the following qualitative disclosures:

- The entity's exposure to the risk and how they arise;
- The entity's objectives, policies, and processes for managing these risks;
- The method/s used to measure these risks; and
- The resulting changes to the above disclosures from previous reporting periods

The above disclosures are required to be presented from the entity's perspective and are designed to highlight the entity's strategy for managing financial instrument risk. While this is a substantial change, it provides a higher level of transparency for the users of the financial statements, essentially highlighting the entity's risk management processes.

When assessing the impact of financial instrument risks on the entity, consideration should be given to:

- credit risk;
- liquidity risk; and
- market risk (including currency risk, interest rate risk and other price risk).

Quantitative Disclosures

AASB 7 prescribes specific disclosures for certain risks, in addition to those previously required by AASB 132, which are described below:

Credit Risk

Disclosure of the following is required:

- The entity's maximum exposure to credit risk, and details of any collateral held;
  - Generally this is the carrying amount less any impairment losses and offsets allowed under AASB 132, for example:
    - when selling goods to a customer and assuming the related receivable the maximum exposure to credit risk is the amount of the financial asset or receivable; or
    - when granting financial guarantees the maximum exposure to credit risk is the amount the entity could be required to pay should the guarantee be called on.
- Information about the credit quality of financial assets that are:
  - Neither past due nor impaired;
  - Past due, but NOT impaired (including the aging of such assets); and
  - Not past due, but impaired (including factors used to determine such assets are impaired).
- An analysis of financial assets which are determined to be individually impaired;
- The carrying amount of financial assets that would have otherwise been past due or impaired, save for a renegotiation of terms;
- Disclosure of any collateral held as security.

Liquidity risk

Disclosure of the following is required:

- A maturity analysis for financial liabilities that shows the remaining contractual maturities and a description of how the inherent liquidity risk is managed.
  - This disclosure will include information regarding:
    - Finance lease obligations;
    - Trade payables; and
    - Bank loans / borrowings.
  - This is to be accompanied by a narrative describing how the liqidity risk inherent to these financial liabilities is managed; i.e. what is the likelihood that the entity will be required to pay its liabilities earlier than expected.

An example of the appropriate time bands for maturity contained in the Appendix to AASB 7 may be:

- Not later than one month;
- Later than one month and not later than three months;
- Later than three months and not later than one year; and
- Later than one year and not later than five years.

Sensitivity Analysis – Market Risk

AASB 7 requires that entities disclose the sensitivity of their results to a movement in market conditions as a result of financial instruments for each component of market risk which an entity is exposed to (e.g. interest rate, currency or other price risk).

Disclosure of the following is required:

- A sensitivity analysis for each type of market risk to which the entity is exposed, and the methods and assumptions used to prepare the analysis (including any changes in assumptions from prior periods)

  - The sensitivity analysis should show the impact of a "reasonably possible change" in market risks on profit and equity.

Note: If the entity prepares a "value-at-risk" analysis or similar in certain circumstances this may be used in place of the sensitivity analysis.

What is a reasonably possible change?

The requirement to disclose the sensitivity of financial instruments to changes in interest rate, exchange rate and commodity prices (i.e. market risks) has been one of much discussion, with some entities seeking to define an industry benchmark.

The major benefit received by defining an industry benchmark is that comparability across entities is increased as a common measure of possible change is chosen.

The requirements of AASB 7, however state that the determination of a reasonably possible change must be tailored to the company and it's circumstances, and should not include remote or 'worst case' estimates.

The determination of a reasonably possible change should not become an onerous task, as the important considerations are the assumptions, rationale and methodology used to prepare the sensitivity analysis, and their appropriate disclosure. This disclosure should be presented such that users of the financial report can understand management's interpretation of the risks facing the entity.

When disclosing the sensitivity of the company's financial instruments to movements in market risk materiality still applies.

Entities also have the option of presenting the analysis on either a pre or post tax basis.

A review of various listed entity financial reports from 31 December 2007 across a range of industries showed the following trends:

Industry	**Responsibly possible change**	
	Interest rate risk	Foreign currency risk
Software & Services	+ 10% or 100 base points - 5% or 50 base points	+ 10% - 5% (USD)
Consumer Services	+ / - 50 base points	+ / - 10% (SGD)
Telecommunication Services	+ / - 1%	+ / - 10% (USD)
Materials	+ / - 50 base points	+ / - 5% (USD and CAD)
Food Beverage & Tobacco	+ / - 10% or 68 base points	+ / - 10% (USD)

How is the impact calculated?

Worked example:

Consider Entity A

- The interest rate paid by their bank on deposits is 5% and the interest rate charged by their financiers is 7% for borrowings. They expect a movement of 10% to be reasonable.
- Cash at bank was $5,000,000 and finance income was $300,000.
- The bank overdraft was $1,000,000 and finance costs were $100,000.

All balances are as at 30 June 2008.

An example of the disclosure in the financial report is:

The following table illustrates the sensitivity of the net result for the year and equity to a reasonably possible change in interest rates of + / -10% (2007: + / - X%), with effect from the beginning of the year. These changes are considered to be reasonably possible based on observation of current market conditions.

The calculations are based on Entity A's financial instruments held at each balance sheet date, with all other variables held constant.

	2008 ($)		**2007 ($)**	
	+10%	-10%	+10%	-10%
Cash and cash equivalents				
Net result	25,000[1]	(25,000)[2]	xx,xxx	(xx,xxx)
Borrowings				
Net result	(7,000)[3]	7,000[4]	(xx,xxx)	xx,xxx

Calculation

5,000,000@ 5% $50,000	$250,000	A	
*5,000,000@ 5.5.% (5% + (5% * 10%)*	$275,000	B	*[1] = B – A $25,000*
*5,000,000@ 4.5% (5% - (8% * 10%)*	$225,000	C	*[2] = C – A ($25,000)*
1,000,000@ 7%	$70,000	D	
*1,000,000@ 7.7% (7% + (7% * 10%)*	$77,000	E	*[3] = D – E ($7,000)*
*1,000,000@ 6.3% (7% - (7% * 10%)*	$63,000	F	*[4] = E – F $7,000*

Action Required

- Entities will need to begin the process of collecting disclosure information required for the comparative and current years;
- Entities are required to assess the appropriateness of their current reporting systems with reference to the required disclosure information. Entities should consider whether there is a need for enhanced or replacement reporting systems and processes so as to accurately and efficiently record the data required for some of the more complex AASB 7 disclosures;
- Key management must develop a communications plan that clearly articulates their strategy for holding financial instruments and how the

associated risks of those financial instruments are managed and mitigated in the overall value-add plan of the entity. While entities may have an informal plan, it must now be formally documented; and
- Entities should discuss the relevant disclosure requirements and information with their auditor / advisor to ensure completeness and accuracy of information.

Conclusion:
For more information on AASB 7 and how Grant Thornton Australia can assist with the transition and implementation of AASB 7, including example disclosures, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au

APPENDIX 1 – SUMMARY OF AASB 7 REQUIREMENTS

BALANCE SHEET DISCLOSURES

1. Carrying amount of each category of financial instrument (paragraph 8)	Financial assets / liabilities at fair value through profit or loss, showing separately - those designated as such upon initial recognition and - those classified as held for trading in accordance with AASB 139 Held-to-maturity investments Available-for-sale financial assets Loans and receivables Financial liabilities measured at amortised cost
2. Financial assets and liabilities at fair value through the profit and loss (paragraph 9 - 11)	Credit risk disclosure including: - Maximum exposure - Mitigating factors - Changes in fair value due to credit risk (and the methods for determining this) - Difference between the financial liability carrying amount and amount
3. Reclassification (paragraph 12)	Where a financial asset is reclassified the amount reclassified and the reason for the reclassification (see paragraphs 51-54 of AASB 139).
4. Derecognition (required by class) (paragraph 13)	Where a financial asset does not qualify for derecognition (see paragraphs 15-37 of AASB 139) disclose - the nature of the asset and the risks & rewards the entity remains exposed to - the carrying amounts of the assets and associated liabilities (when the entity continues to recognise all of the assets) and - the total carrying amount of original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities (when the entity recognises the assets to the extent of its continuing
5. Collateral (paragraph 14 – 15)	Carrying amount of financial assets pledged as collateral for liabilities or contingent liabilities and the terms and conditions relating to its pledge.