

## IFRS 7 Under the Hood - Issue 1

As of 1 January 2007, IFRS 7 became a reality for all financial reporting entities. IFRS 7 replaces and updates the disclosure requirements of IAS 32 and supersedes IAS 30. It requires highly detailed quantitative and qualitative disclosures of the financial risks faced by companies.

Most companies are still coming to grips with this new Standard and this is fuelling a desire for a greater understanding of its implications and the changes that it will bring. This article is the first in a series that will discuss the rationale behind the Standard and best practice compliance.

### What is IFRS 7?

According to Sir David Tweedie, IASB Chairman, "IFRS 7 will lead to greater transparency about the risks that entities run from the use of financial instruments. This, combined with the new requirements in IAS 1, will provide better information for investors and other users of financial statements to make informed judgements about risk and return."

Specifically IFRS 7 requires companies to provide disclosures which enable stakeholders to evaluate:

- the significance of financial instruments to the company's financial position and performance
- the nature and extent of risks arising from financial instruments to which the company was exposed during the period and at the reporting date (quantitative disclosures)
- the approach taken in managing those risk (qualitative disclosures)

### 'Through the eyes of management'

Critically, the enhanced disclosures should reflect how senior management *itself* measures and manages their company's financial risks. According to the Standard, "companies must provide information about the extent to which they are exposed to financial risks, based on information provided internally to the entity's key management personnel."

This increasing alignment between internal and external reporting has been a key goal of the new International Accounting Standards which are now well on their way to overhauling and standardising financial reporting and disclosures.

### Opportunity or burden?

For the first time IFRS 7 presents companies with the opportunity to demonstrate their comprehensive ability to manage financial risk. Companies which embrace IFRS 7 can use it as a catalyst to review their overall risk management practices and policies and ensure that they represent best practice.

Boards should consider the key messages they wish to convey in their financial statements but should also ensure that the information is succinctly presented, easily understood and comparable with the company's peer group. Companies which act quickly to create a clear and effective format will set a competitive lead for others to follow.

On the flip side, additional financial instruments disclosure could expose any flaws in a company's risk management policies or processes, highlight excessive financial risk and put the effectiveness and consistency of risk management strategies under market scrutiny.

### What financial risks does IFRS 7 encompass?

IFRS 7 seeks to provide additional disclosure for the full gamut of financial risks, including market, credit and liquidity risk. The Standard's definition of these is given for reference below:

#### IFRS 7 Key definitions:

<b>Credit risk</b>	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
<b>Liquidity risk</b>	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities
<b>Market risk</b>	The risk that the fair value or future cash flows of a financial instruments will fluctuate because of changes in market prices. Market risk comprises three types of risk: <b>currency risk</b> , <b>interest rate risk</b> and <b>other price risk</b> .
<b>Currency risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
<b>Interest rate risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
<b>Other price risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from <b>interest rate risk</b> or <b>currency risk</b> ), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Source: International Accounting Standards Board, IFRS 7 'Financial Instruments: Disclosures'

### Making the most of IFRS 7

Companies wishing to make the most of IFRS 7 should follow a broad three stage process:

1. Determine the key strategic messages they wish to communicate to the market through their enhanced disclosures.
2. Identify any additional internal data gathering or work required to be able to deliver the enhanced disclosures. As part of this management should select the most appropriate analytic methodology for quantitative market risk disclosure. The pros and cons of using sensitivity analysis versus a Value-at-Risk approach should be carefully evaluated.
3. Implement a timetable to gather, refine, verify and publish all the information required

If IAS 39 represented the engagement between treasurers and accountants, then IFRS 7 is the marriage. To optimally prepare for IFRS 7, close communication between treasury and accounting functions will be vital. Those preparing financial statements must fully understand the nature and basis of the financial risk disclosures that are being presented.

A critical requirement for IFRS 7 will be the need to implement adequate systems and processes to easily and consistently deliver all of the required output. This means that either sophisticated spreadsheets or off-the-shelf treasury systems will be needed. It is highly likely that the growing compliance burden resulting from standards such as IFRS 7, IAS39 and SOX will ultimately push many companies away from complex and error-prone spreadsheets into dedicated treasury systems.

### **Time is of the essence**

It is important to note that, from the first year of introduction, IFRS 7 requires prior financial year comparatives. In addition, companies will need to state whether their financial risk disclosed at year end was materially different from that exposed to during the year. This could possibly require minimum, maximum and average financial risk measurements for the preceding financial year to be calculated and disclosed. Given most companies will include IFRS 7 disclosures from June next year, companies should ensure they have an accurate grasp of their current financial risk, especially at their most recent year end.

As a very first step we recommend looking at the information presented online in the Big Four Accounting Firms' model financial statements. Annual Reports from early adopters such as Telstra and Origin Energy also provide a valuable guide.

### **Next issue**

Our next issue will focus on the most difficult requirement of IFRS 7: how to quantify and present exposure to market risk.

### **References and additional information**

Please contact us if you have trouble accessing any of the references mentioned in this article, or for additional information on successfully complying with IFRS 7.

### **Previous Issues of Under the Hood**

Previous issues of Under the Hood covering the topics of valuation and hedge accounting are available from our website. Please visit: [http://www.visualrisk.com/01\\_company/newsletters.html](http://www.visualrisk.com/01_company/newsletters.html)