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Briefing Paper

FRS 29 (IFRS 7) Financial Instruments: Disclosures

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PART 1

Executive Summary

This Briefing Paper is not a substitute for reading the Financial Reporting Standards and interpretations themselves. The material in this publication is based on current interpretations of the relevant Financial Reporting Standards at a particular point in time and does not take account of requirements in order to comply with local and European legislation.

Readers should not act on the basis of this publication without seeking appropriate professional advice. The IFIA can accept no responsibility for loss to any person or organisation acting or refraining from acting as a result of any material in this publication.

Introduction

FRS 29 (IFRS 7) Financial Instruments: Disclosures was issued by the Accounting Standards Board (ASB) on 9 December 2005. This Financial Reporting Standard (FRS or Standard) has the effect of implementing the International Accounting Standards Board's (IASB's) International Financial Reporting Standard (IFRS) 7 'Financial Instruments: Disclosures' in the UK and Republic of Ireland for entities not preparing their financial statements in accordance with International Financial Reporting Standards. This Standard sets out requirements for disclosures relating to financial instruments and capital.

In recent years there have been significant developments in risk management concepts and practices. New techniques have evolved for measuring and managing exposures to risks arising from financial instruments. Financial statement users and other investors need such information to make more informed judgements about the level of risks an entity is exposed to, through investing in financial instruments. As a result IFRS 7 was issued by the IASB. Subsequently, FRS 29 was issued by the ASB to implement the revised disclosures into Irish and UK GAAP.

The objective of FRS 29 is to provide information to users of financial statements about an entity's exposure to material risks and how the entity manages that risk. To this end the FRS requires an entity to provide disclosures in its financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance, and the nature and extent of risks arising from financial instruments to which the entity is exposed (quantitative disclosures) and how the entity manages those risks (qualitative disclosures).

The FRS takes a different approach from previous standards in relation to the disclosures of qualitative and quantitative information of an entity's exposure to risks arising from financial instruments. The FRS expands the qualitative disclosure to include information on the process that an entity uses to manage and measure risk, based on information provided internally to key management personnel.

This briefing paper attempts to summarise and explain the new disclosures which are required under the Standard and to provide practical answers to some of the questions which may arise from implementation of the Standard in the key areas of credit risk, liquidity risk and market risk.

Scope and Applicable Dates

This Standard applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss subject to the certain exemptions, including:

- Reporting entities applying the Financial Reporting Standard for Smaller Entities (FRSSE).
- Entities that are not applying FRS 26 are exempt from this Standard.

- The following entities are exempted from this Standard:
 - subsidiary undertakings, other than banks or insurance companies, 90 percent or more of whose voting rights are controlled within the group (provided the entity is included in publicly available consolidated financial statements which include disclosures that comply with this Standard)
 - parent companies in respect of their single-entity financial statements [again provided the entity is included in publicly available consolidated financial statements which include disclosures that comply with this Standard.)

- Although not mandatory, entities that are not applying FRS 26 are encouraged to comply with the disclosure requirements of this Standard.

In applying the requirements of the Standard it is important to bear in mind the exemptions from certain of these disclosures (e.g. sensitivity analysis) provided in the Standard where it is judged that “the risk is not material”. Therefore determining which risks are material will be a key element in implementing the disclosure requirements of the Standard.

FRS 29 must be adopted by those entities which apply FRS 26 in preparing their financial statements for accounting periods beginning on or after 1 January 2007 and supersedes, in full, the disclosure requirements of FRS 25 Financial Instruments: Disclosure and Presentation. The FRS will require restatement of comparatives and also will apply to the first set of interim accounts produced for annual accounting periods beginning on or after 1 January 2007.

PART 2
FRS 29 Background, Questions
and Answers

MARKET RISK DISCLOSURES:

Background

Definitions:

Market Risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

Other price risk

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 interest rate risk and currency risk), whether those changes are caused by factors specific to individual financial instruments or its issuer, or other factors affecting similar financial instruments traded in the market.

Qualitative disclosures

For market risk, a fund is required to disclose, in narrative format, a discussion on the exposures to market risk and how they arise; the objectives, policies and processes for managing the risk; and any changes in these from the prior year.

To date the type of information provided by funds has tended to be relatively generic in respect of the disclosure on risks and has not necessarily focussed on the fund's policies and processes for managing the risk. It is therefore expected that the disclosures will be more extensive and more specific to the actual policies employed by a fund. In respect of UCITS III funds, it is likely that the business plan and risk management policy filed with the Financial Regulator will be a key source of information.

It is helpful to note that the Standard permits cross referencing from the audited financial statements to other parts of the annual report for these disclosures. Therefore to the extent that the directors' report or the Investment Manager's report contains sufficient detail on market risk further or repetitive disclosure in the notes to the financial statements may not be necessary.

Quantitative Disclosures

Exposure to Market Risk

A fund is required to disclose summary quantitative data about its exposure to market risk at the reporting date. The key element of the Standard is that the quantitative information should be based on information provided internally to key management personnel of the fund. Key management is defined as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. From this definition, it is clear that information provided to the Board of Directors is one basis for the disclosures but the definition would also require the fund to consider information provided or used by the investment manager.

Under current disclosures, the schedule of investments tends to give a snap shot at the reporting date of the key market risk exposure as it classifies the portfolio into key elements such as currency, instrument type (e.g. equity) and geographic location.

However, for each fund the adequacy of the split within the schedule of investments will need to be considered against that information provided and used by key management. In most cases, interest rate risk exposure is not provided in sufficient detail by the schedule of investments and therefore an interest rate table presenting the key interest rate classifications will need to be provided where there is significant exposure to interest rate risk.

Sensitivity Analysis

In addition to the exposure to market risk, the fund must provide a sensitivity analysis in respect of market risk. There are two options for the presentation of the sensitivity analysis:

1. If key management prepares a sensitivity analysis that reflects interdependencies between risk variables such as a value at risk methodology (VaR), this may be used. Where VaR is used, the fund must disclose the main assumptions and parameters used in the methodology, for example, holding period and confidence level. The objectives and the limitations of the method must be disclosed; or
2. The fund must present a different form of sensitivity analysis for each component of market risk, namely, currency risk, interest rate risk and other price risk.

Where another form of sensitivity analysis is provided for each risk variable, the sensitivity analysis should show the effect of a reasonably possible change in the relevant risk variable on the fund's profit loss and equity at the reporting date. The analysis should reflect both an upwards and downwards movement in the variable. The methods and assumptions used in the analysis must be provided along with any changes and the reasons for such changes since the prior period.

Questions and Answers:

1. Are tables required for exposure to each of currency risk, market price risk, interest rate risk?

Quantitative information is required on each risk component. However, the Standard does not mandate the specific form in which this information should be presented. The Standard allows for cross referencing from the notes to the financial statements to where the information is provided. In the case of many funds, the quantitative information on exposure may be adequately covered within the schedule of investments and therefore will not need to be repeated in the notes to the financial statements. Alternatively, if such information is given elsewhere in the annual report (for example, in the investment managers' report) it can be cross referenced to that disclosure. A table disclosure would generally be used in practice for the quantitative disclosures.

2. *Is quantitative information required by sub fund?*

As the information presented should be based on information used by key management, it is likely that the information would be provided on a sub fund basis as risks are typically managed on a sub fund basis.

3. *Is the sensitivity analysis required for Market Risk, Interest Rate Risk, Credit Risk and Currency Risk?*

Sensitivity analysis is only required for market risk which incorporates interest rate risk, currency risk and other price risk but not credit risk. If the fund prepares the sensitivity analysis using a method that reflects interdependencies between risk variables (such as Value at Risk) then disclosures in respect of this analysis may be given. Otherwise disclosures of sensitivity analysis must be provided for each of currency risk, interest rate risk and other price risk where these risks are judged to be material. No sensitivity analysis is required for credit risk.

4. *Who prepares the sensitivity analysis?*

As the directors are ultimately responsible for the preparation of the financial statements, it is the directors who will need to ensure the disclosures are prepared. In practice, it is likely that the investment manager will be in the best position to provide the information and may already be carrying out certain analysis. However, as the detail included in the notes is subject to audit, the information supporting the disclosures will need to be maintained and accessible to the auditor, therefore, the administrator may need to maintain the support for any disclosure provided by the investment manager.

5. *What is the basis for determining the extent of the change in risk variable used within the sensitivity disclosure i.e. is there a specific basis points movement effect required?*

The Standard does not prescribe a specific basis point movement or percentage movement for any of the risk variables. The sensitivity analysis is required to show the effect on the profit and loss of a reasonably possible change in the relevant risk variable. The analysis therefore does not require remote or “worst case” scenarios and the assessment of the reasonably possible change should be over the period to the next reporting period. Furthermore, where there is range of possible changes, it is not required to present an analysis for each movement within the range. The analysis should reflect the limit of the reasonably possible range.. The ASB have intentionally not given any guidance in the Standard due to the fact that the effect of a reasonably possible change will be different based on the applicable economic environment. The fund will need to judge what a reasonably possible change is.

6. *How should the sensitivity analysis be prepared for a fund of funds?*

The Standard doesn't give clear guidance on situations such as funds of funds, however, the Standard does recognise that the sensitivity analysis may have limitations. The Standard requires that where a sensitivity analysis is unrepresentative of the risk inherent in the financial instrument further disclosure is required. In the case of fund of funds, a simple sensitivity analysis to either equity market movements or currency risk will not reflect the potential for risks inherent in each of the portfolios

within each individual fund. No guidance is given on the extent of the disclosure in respect of an unrepresentative sensitivity analysis. It would be expected that the disclosures would reflect the analysis used by the fund in managing its exposures to the underlying funds and consider sensitivity analysis based on movement in specific hedge fund indices or benchmarks of underlying funds.

7. Does the fund need to prepare comparative information?

Yes. There is no exemption from presentation of comparative information when the fund adopts the Standard in an accounting period beginning on or after 1 January 2007.

Currency Risk

Definition:

Currency risk is defined in the FRS as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. It is defined as one of the components of Market Risk.

Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured. For the purpose of this Standard, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.

As currency risk is a component of Market Risk it does require a sensitivity analysis to be prepared where the risk is judged to be material to the fund. A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Question

Is the analysis required for all currencies held by the fund other than the Functional Currency?

Answer

Management will need to exercise their judgement to determine which foreign currencies are significant and hence require qualitative and quantitative disclosure in the financial statements. If a currency is not viewed as significant no disclosure is required.

In addition the FRS states that a sensitivity analysis is required for each currency to which an entity has significant exposure. This sensitivity analysis will typically disclose the impact on the net profit for the year of movements in foreign exchange rates that are significant to the fund.

Typically disclosures will also be given in relation to the fund's policy in respect of currency hedging transactions.

CREDIT RISK DISCLOSURES

Background

The Standard defines credit risk as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. It can arise from granting loans and receivables to another party, placing deposits with other entities, entering into derivative contracts, granting financial guarantees, and making loan commitments.

Where a fund is exposed to credit risk, there are some significant changes in the disclosures required from those applying under FRS 25. These are unlikely to have much impact on funds that invest predominantly in equities but a fund that has, for example, significant holdings in bonds or derivatives is likely to have to consider whether additional information should be provided. Credit risk can also apply to debt and cash balances.

FRS 29 requires disclosure of credit risk in the financial statements of all entities with credit risk exposure. This includes both summary and specific disclosures and these are set out below. FRS 29 introduces new additional credit risk disclosures including:

- Information about the credit quality of financial assets that are neither past due nor impaired;
- The carrying amount of financial assets whose terms have been renegotiated where the relevant assets would otherwise have been past due or impaired; and
- An analysis of the age of financial assets that are past due as at the reporting date but not impaired.

Nature and extent of credit risk

The over-arching requirement is for the disclosure of information that enables users of the financial statements to evaluate the nature and extent of credit risk arising from financial instruments to which the fund is exposed at the reporting date, including how the risk has been managed.

Qualitative disclosures

The financial statements should disclose:

- the exposures to credit risk and how they arise;
- the objectives, policies and processes for managing the credit risk and the methods used to measure the risk;
- any changes in the exposures to risk and how they arise from the previous period;
- any changes in the objectives, policies and processes for managing the risk and the methods used to measure the risk from the previous period.

It is likely that the Investment Manager and administrator will need to work together in producing the information required for credit risk. The Investment Manager will provide information on impairment of assets, qualitative disclosures etc.

The administrator should set the requirements for the format and back up to the information provided. This will then need to be approved by the directors of the fund.

Summary quantitative disclosures

There are two broad disclosures required in relation to credit risk.

- Summary quantitative data about exposure to credit risk at the reporting date, based on the information provided internally to key management personnel, for example the fund's directors. For a fund this is likely to be generated by the Investment Manager. Where a fund uses several methods to manage a risk exposure, the disclosure should be based on the method or methods that provides the most relevant and reliable information.
- The concentration of credit risk covering:
 - any concentrations of risk, if not apparent from the above summary quantitative disclosures or specific disclosures referred to below;
 - a description of how the Investment Manager determines concentrations;
 - a description of the shared characteristic that identifies each concentration (such as counterparty, geographical area, currency or market);
 - the amount of the risk exposure associated with all financial instruments sharing that characteristic.
- If the quantitative data (either summary or specific (see below)) disclosed as at the reporting date is unrepresentative of a fund's exposure to credit risk during the period, further information that is representative should be provided.

Specific disclosures

These are required to the extent that they are not covered in the summary disclosures. The disclosure is not required where the risk is not material.

In preparing financial statements, a fund will be required to disclose, by class and grouped into classes that are appropriate to the nature of the information disclosed and that takes into account the characteristics of those financial instruments:

- the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with FRS 25). However, this should be net of amounts offset that are in accordance with FRS 25 or any impairment losses recognised in accordance with FRS 26. The disclosure of credit risk may be impacted by Master Netting Arrangements ("MNA") in place for the fund. If the MNA permits netting off of balances on default then the credit risk note should reflect the net risk only. If netting is not permitted the amounts disclosed in the credit risk note will cover the asset balance only. This may result in the fund disclosing significant credit risk balances;
- sufficient information about the classes to allow reconciliation to the line item presented in the balance sheet;
- a description (not the amount) of collateral held as security and other credit enhancements for the amounts disclosed above;

- information about the credit quality of financial assets that are neither past due nor impaired; and
- the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

These tables should distinguish between financial instruments measured at amortised cost from those measured at fair value.

One of the main areas where new disclosures may need to be considered is the provision of information about the credit quality of financial assets. FRS 29 does not mandate any specific form in which this information should be given. It may include ratings from a credit ratings agency or the financial statements may instead describe credit quality in more general terms.

Additional information is required for financial assets that are past due or impaired. Past due occurs where a counterparty has failed to make a contractual payment. For these financial assets, in addition to providing information to permit reconciliation to the line item in the balance sheet, the collateral held by the fund as security, credit enhancements and the fair value (unless impracticable) the financial statements should also include:

- for each class, an analysis of the age of financial assets that are past due at the reporting date but not impaired; and
- an analysis of financial assets that are individually determined to be impaired at the balance sheet date. This should include the factors considered in determining impairment.

Questions & Answers

1. What rating agencies are to be used?

FRS 29 does not set a requirement to use ratings from a specific, or any, credit rating agency. However, if a fund is considering providing specific credit rating information this is an area where there may be difficulty in ensuring that permission is obtained for publishing rating data in annual reports. It may be useful to discuss this in advance with the ratings agency and approval obtained.

2. Is the table at a Fund or Umbrella level?

The tables of quantitative information will be required at the level of information produced in the balance sheet. If the financial statements include information at fund and umbrella level then the credit risk table will need to be prepared on the same basis. The requirement to include fund and umbrella information may depend on the structure of the fund.

3. Is Master netting arrangement disclosure compulsory?

There is no requirement to disclose the Master Netting Arrangement in place but it may be considered good practice to do so.

4. Will information on credit risk come from the Fund Investment Manager?

It is likely that the investment manager and administrator will need to work together in producing the information required for credit risk. The Investment Manager will need to provide information on impairment of assets and the qualitative disclosures as they are likely to be the only party with this knowledge and information. The administrator should consider setting the requirements for the format and back up to the information provided with the Investment Manager in advance of the production of financial statements. The information provided will need to be approved by the directors of the fund as part of its inclusion in the financial statements.

LIQUIDITY RISKS DISCLOSURES:

Background

FRS 29 defines liquidity risk as “the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities” and requires that an entity discloses specific information in relation to the liquidity risk arising from financial instruments.

The entity must make the following *qualitative disclosures* in relation to liquidity risk:

- (a) the exposures to liquidity risk and how they arise;
- (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- (c) any changes in (a) or (b) from the previous period.

The entity must make the following *quantitative disclosures* in relation to liquidity risk:

- (a) summary quantitative data about its exposure to liquidity risk at the reporting date. This disclosure shall be based on the information provided internally to key management personnel of the entity for example the entity’s board of directors and chief executive officer;

When an entity uses several methods to manage a risk exposure, the entity should disclose information using the method or methods that provide the most relevant and reliable information.

- (b)
 - (i) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and
 - (ii) a description of how it manages the liquidity risk inherent in (i).

This information should be disclosed to the extent that it is not provided in (a) above, unless the risk is not material; and

- (c) concentrations of risk if not apparent from (a) and (b).

Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity. Disclosure of concentrations of risk should include:

- (i) a description of how management determines concentrations;
- (ii) a description of the shared characteristic that identifies each concentrations (eg counterparty, geographical area, currency and market); and
- (iii) the amount of the risk exposure associated with all financial instruments sharing that characteristic.

If the quantitative data disclosed as at the reporting date is unrepresentative of an entity's exposure to risk during the period, the entity must provide further information that is representative.

Contractual Maturity analysis

As indicated in (b) above under quantitative disclosures, financial liabilities must be disclosed by contractual maturity. The Application Guidance of FRS 29 suggests, rather than prescribes, timeframes that may be used in preparing the contractual maturity analysis for liabilities. For example, an entity might determine that the following time bands are appropriate:

- 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.

When a counterparty has a choice of when an amount is paid, the liability is included on the basis of the earliest date on which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (eg demand deposits) are included in the earliest time band.

The amounts disclosed in the maturity analysis are the contractual undiscounted cash flows, for example:

- (a) gross finance lease obligations (before deducting finance charges);
- (b) prices specified in forward agreements to purchase financial assets for cash;
- (c) net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;
- (d) contractual amounts to be exchanged in a derivative financial instrument (eg a currency swap) for which gross cash flows are exchanged; and
- (e) gross loan commitments.

If appropriate, an entity shall disclose the analysis of derivative financial instruments separately from that of non-derivative financial instruments in the contractual maturity analysis for financial liabilities. For example, it would be appropriate to distinguish cash flows from derivative financial instruments and non-derivative financial instruments if the cash flows from derivative financial instruments are settled gross. This is because the gross cash outflow may be accompanied by a related inflow.

When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the reporting date. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the reporting date.

Questions & Answers

- 1. Why do the cash flows in relation to financial liabilities which are included in the contractual maturity analysis differ to the amount included in the balance sheet?**

The undiscounted cash flows per the contractual maturity analysis differ from the amount included in the balance sheet because the balance sheet amount will be based on discounted cash flows.

- 2. Will the redeemable participating shares of a fund be included in the contractual maturity analysis?**

All financial liabilities should be included in the contractual maturity analysis. The redeemable participating shares of a fund are redeemable on demand at the shareholder's option and as such are classified as a financial liability. The fund will be exposed to the liquidity risk of meeting shareholder redemptions at any time, in particular where the underlying investments cannot be readily disposed of to meet redemption demands.

- 3. Should the entity disclose the cash flows from derivative financial instruments separately from those of non-derivative financial instruments in the contractual maturity analysis?**

Yes. FRS 29 Appendix B15 states that it would be appropriate to distinguish cash flows from derivative financial instruments and non-derivative financial instruments if the cash flows from the derivatives are settled gross as the gross cash outflow may be accompanied by a related inflow. For example, when a net cash flow will be exchanged for pay float/receive fixed interest rate swaps, the net amount can be included with the cash flows from non-derivative financial instruments. However, contractual amounts for derivative financial instruments which settle on a gross basis, such as a currency swap would need to be included separately in the maturity analysis based on gross cash flows.