IAASA

Irish Auditing & Accounting Supervisory Authority

Review of the quality of selected debt and fund issuers' fair value and risk disclosures

MISSION

TO SUPPORT AND ENHANCE PUBLIC CONFIDENCE IN THE ACCOUNTANCY PROFESSION AND IN FINANCIAL REPORTING THROUGH THE EXERCISE OF EFFECTIVE, INDEPENDENT OVERSIGHT AND THE PROMOTION OF ADHERENCE TO HIGH STANDARDS

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The purpose of this document is to provide details of the outcome of a review of the quality of selected debt and fund issuers' risk and fair value disclosures, as set out in their annual financial reports. It does not constitute legal advice or a legal interpretation and is not, therefore, intended as a substitute for a detailed review of the relevant legislation or accounting standards. Where users of this document are uncertain regarding the effect of any legal provision, consideration should be given to obtaining independent legal advice.

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1 Executive summary

1.1 Introduction
This document provides details of the results of a review of the quality of selected debt and fund issuers'[1] fair value and risk disclosures in respect of financial instruments, as contained within those issuers' annual financial reports. The purpose of this document is to assist those charged with the governance and management of debt and fund issuers to improve the standard of their reporting in this area.

1.2 Summary findings
The Irish Auditing & Accounting Supervisory Authority ('IAASA') reviewed a sample of 14 debt and 6 fund issuers' annual financial reports, all in respect of financial years ending during the calendar year to 31 December, 2010.

This review of the quality of debt and fund issuers' fair value and risk disclosures has identified deficiencies in the nature of the information provided to users. In particular, debt issuers' financial reports were, in some instances, found to contain significant non-compliance with the disclosure requirements of IFRS 7/ FRS 29 *Financial Instruments: Disclosures*.

This is a disappointing, although not surprising, outcome given IAASA's previous experience of reviewing the financial reports prepared by entities coming within this constituency.

It is frequently suggested that IFRS 7 is not suited to the needs of fund and debt issuers. However, despite the fact that IFRS 7 permits a degree of latitude for an entity to decide how much detail it provides, how much emphasis it places on different aspects of the requirements and how it aggregates information, the majority of issuers in the sample did not provide tailored disclosures that they deemed more representative of their circumstances.

IAASA's review of debt and fund issuers' fair value and risk disclosures has identified the following principal findings:

- a majority of the sampled issuers' disclosures included a menu of possible valuation techniques that could be used to value financial instruments rather than providing a description of the actual valuation techniques applied;

- debt issuers typically applied too narrow an interpretation of who could be considered users of their financial statements and, therefore, provided only limited decision useful disclosures about risk; in particular, the failure to identify noteholders as a significant user was a common failing;

- descriptions of policies and processes for managing risks arising from financial instruments (qualitative disclosures) were often generic statements, boilerplate and not user specific, and contained insufficient detail to provide any meaningful explanations;

- disclosures by class of financial instrument were frequently absent from issuers' reports despite the presence of financial instruments with dissimilar characteristics;

- where changes in fair values or individual risks (for example other price risk, credit risk and counterparty risk) occurred in the period, most issuers did not provide details of the changes in risks or explanations of the reasons for, or impact of, those changes;

- failure to explain other price risk or to provide the information necessary to explain the nature of its components or changes therein, as well as presenting information in too aggregated a form; and

[1] Entities whose securities are admitted to trading on a regulated market, situated, or operating, within the EU/EEA and whose home member state is Ireland i.e. entities falling within the remit of the Transparency (Directive 2004/109/EC) Regulations 2007

- management report disclosures in respect of performance lacked entity specific information as well as sufficient analysis necessary to understand the components of overall performance and failed to address future developments.

Notwithstanding the range of deficiencies identified in this document among closed ended funds and, particularly, amongst debt issuers, there were some examples of good quality financial instrument disclosures. Furthermore, it should be noted that the nature of the information identified as lacking in the financial statements is not necessarily indicative of measurement issues. Rather, enhanced disclosures would assist users of those financial statements in understanding the performance, financial position and potential variability of future cash flows.

1.3 Recommendations

In preparing future annual financial reports, fund and debt issuers need to improve the quality of the fair value and risk disclosures contained therein. This document suggests ways in which this might be achieved. In summary, it is recommended that issuers should:

- provide specific, tailored disclosure, as opposed to voluminous generic disclosures, to improve the decision usefulness of fair value and risk information;

- avoid a '*same as last year*' approach towards the preparation of fair value and risk disclosures, and ensure that the issuer's current circumstances are reflected in such disclosures. The fair value and risk disclosures should be seen as a dynamic and fluid part of the annual report that need to be re-examined each period;

- ensure that financial instruments with dissimilar characteristics are not inappropriately aggregated for the purposes of disclosure; and

- in the case of debt entities, recognise that noteholders are a key user of the financial statements, and ensure that fair value and risk disclosures address their requirements.

2 Background to the review

2.1 Introduction and purpose of the review
Since it commenced its financial reporting review activities in 2007, IAASA has examined the financial reports of a significant proportion of the debt, fund and equity issuers coming within its remit[2].

As was noted in IAASA's most recent Annual Report, despite the large number of fund and debt issuers that have been the subject of IAASA reviews to date, non-compliance with certain requirements of the relevant reporting framework continues to be a feature within these two constituencies. In that context, IAASA indicated that it was considering a number of additional initiatives in order to address certain shortcomings in these constituencies' financial reporting. This review, which focuses on selected debt and fund issuers' fair value and risk disclosures, is one such initiative.

This document provides details of the results of a review of the quality of selected debt and fund issuers' fair value and risk disclosures in respect of financial instruments, as contained within those issuers' annual financial reports. The purpose is to assist those charged with the governance and management of debt and fund issuers to improve the standard of their reporting in this area.

The audience for this document is principally intended to be those involved in the preparation, approval and review of issuers' annual financial reports, including issuers' accountants, senior management, Audit Committees, Boards, providers of audit and other assurance services, legal advisors, listing agents and, where applicable, fund administrators and other relevant service providers. In that context, IAASA encourages the widest possible transmission of this document.

It is important to note that the infringements identified are not necessarily representative of the quality of the financial reports of debt and fund issuers that do not fall within IAASA's financial reporting review remit. However, it would be expected that the observations on fair value disclosures and risk reporting contained in this document are of relevance to the aforementioned wider body of debt and fund issuers.

2.2 Financial reports forming the basis of the review
IAASA's total debt and fund issuer review constituency comprises of 129 issuers (i.e. 92 debt and 37 fund issuers) [3], who publish approximately 232 periodic financial reports per annum (i.e. 103 half-yearly financial reports and 129 annual financial reports). This document presents the results of a detailed review of a sample of 14 debt and 6 fund issuers' most recent annual financial reports at the time the review was conducted, all in respect of financial years ending during the calendar year to 31 December, 2010.

Background – closed ended funds
These issuers are typically characterised by their investment in illiquid assets and/or investments that require a medium/long term horizon to return capital gains. For this reason, they are more suited to the structure of closed ended funds where investors must commit a predetermined amount of capital for a fixed period of time. The majority of fund issuers coming within IAASA's review remit (i.e. closed ended funds[4]) fall within the following categories: venture capital/private equity funds, funds investing in other illiquid assets e.g. property investments, and equity buy-out funds.

[2] Further information regarding IAASA's financial reporting review activities can be obtained from chapter 4 of its previously published Annual Reports and from its Observations documents, all of which can be accessed at http://www.iaasa.ie/publications/index.htm
[3] As at 31 December, 2010
[4]The Central Bank has issued guidance on the definition of a closed ended fund as *"A collective investment undertaking which does not permit the redemption of its units at the holders' request...."*

Background[5] – issuers of debt
The majority of debt issuers within IAASA's review constituency fall into the following categories:

(i) *asset backed notes/debt:* proceeds from the notes/debt issued are used to invest in a portfolio of investments which are pledged as collateral to the related noteholders (so called '*pass through*' securities);

(ii) *credit linked or derivative backed notes/debt:* the nominal value of the notes/debt issued is invested, through a counterparty, in derivatives. The fair value of the derivative, and consequently the return due to the noteholders, is dependent upon both the return from a specified portfolio of notional investments and the creditworthiness of the derivative counterparty (rather than based on the returns of the actual investments); and

(iii) *funding vehicle for related or affiliated group companies:* a vehicle where the entity raises funds through the issuance of listed notes/debt and the proceeds are used to acquire the investments of one particular entity (as opposed to a diverse portfolio of investments). Due to the concentration of investments, there are often a small number of counterparties, many of whom may be related parties. Income from the investments may be guaranteed by another group company, or otherwise affiliated entity, whose investments the company has acquired.

The sample, which represents 15% of debt issuers and 16% of funds coming within IAASA's review remit, was selected to include issuers with a range of characteristics present in the total population (e.g. to cover the different types of business models) as well as to include issuers serviced by a range of auditors and administrators.

Furthermore, as a large majority of issuers coming within IAASA's remit use either IFRS or Irish GAAP[6], the observations offered in this document are confined to the requirements as they apply to IFRS and Irish GAAP issuers. The relevant international accounting standard is IFRS 7 *Financial Instruments: Disclosures*. FRS 29 *Financial Instruments: Disclosures* is the equivalent standard applying under Irish GAAP. Readers should note that, throughout this document, where reference is made to IFRS 7, it should equally be read as referring to the requirements of FRS 29.

[5] For a description of how debt issuers forming the basis of this review are structured refer to paragraph 4.3.
[6] Generally Accepted Accounting Principles

3 Fair value disclosures

3.1 Introduction to fair value disclosures

The impact of the global financial crisis on the fair value of certain financial instruments has resulted in an increase in illiquidity and volatility in the fair values of selected financial instruments. The absence of an observable market price has increased the necessity for issuers to select and apply valuation techniques to determine the fair value of such financial instruments. The selection of which valuation technique to apply as well as the assumptions underpinning those techniques requires the exercise of experienced judgement by those charged with governance of the entity.

3.2 Fair value disclosures required by IFRS 7

IFRS 7.27 requires the disclosure of the methods and, where a valuation technique is used, the assumptions applied in determining the fair values of each class of financial asset and financial liability as well as details of any change in valuation technique and the reasons for the change. Furthermore, on the basis that fair values estimated by valuation techniques are more subjective and more prone to variability than those established from an observable market price, IFRS 7.27B(e) requires disclosure of information about the effect on fair value of reasonably possible alternative assumptions, including details of how the effect was calculated. Such information is intended to provide users with sufficient information to enable them to assess the extent of subjectivity in the fair value estimate of a financial instrument.

3.3 Findings of the review

IAASA's review of debt and fund issuers' annual financial reports identified that, in many cases, disclosures about valuation techniques demonstrated:

- a failure to identify the specific valuation techniques applied by the issuer in question;
- a failure to disclose whether there had been any changes in the valuation techniques used during the year, and if so, the reasons for making the changes; and
- a failure to disclose details of the effect of reasonably possible alternative assumptions.

A large majority of the annual financial reports reviewed described a menu of possible valuation techniques that could be used to value financial instruments rather than providing a description of the actual valuation techniques applied by the issuer. As a consequence, it was not possible, in most cases reviewed, to establish the specific valuation methodology used to determine the fair values of the issuer's financial instruments where a valuation technique was used i.e. Level 2 and Level 3 prices[7]. Furthermore, in only 2 out of the 20 disclosures reviewed was there any distinction made in respect of the valuation methodologies adopted by class of financial instrument or disclosure of details regarding the most significant assumptions underpinning their valuation techniques by class of financial instrument.

Examples of insufficient disclosures in this regard included:

> *'…fair value is based on quoted market prices… <u>where these are available.</u>'*
>
> *'…if a quoted market price is not available fair value <u>may</u> be estimated by the directors based on …<u>other</u> valuation techniques that provide an estimate of prices.'*
>
> *'…the determination of fair values of financial assets, financial liabilities and derivatives are based on a combination of quoted prices and valuation models…'*
>
> *<u>'Some or all of the inputs</u> into these models may not be market observable.'*

In the case of 19 out of 20 issuers, it was not possible to determine whether there had been changes in the type of, or frequency of use of, particular valuation techniques during the year. A failure to

[7] Level 2 prices use inputs other than quoted prices that are observable. Level 3 prices use inputs that are not based on observable market data.

disclose such changes is all the more disappointing given that 6 out of 20 issuers disclosed significant transfers between Levels 1, 2 or 3 prices and, therefore, such changes in techniques were likely to have occurred during the period.

Similarly, most issuers with financial instruments classified as Level 3 failed to disclose whether changing one or more of the inputs to reasonably possible alternative assumptions would change fair values significantly. Only 2 issuers provided details of reasonably possible valuation spreads for Level 3 securities by class of investments (equity & long term bonds), together with a qualitative explanation as to the basis for the alternative valuation.

3.4 Recommendations for improvements in fair value disclosures

In preparing future annual financial reports those charged with governance of fund and debt entities need to improve the quality of their fair value disclosures. This can be achieved by:

(i) unambiguously stating, by class of financial instrument, the specific valuation techniques and underlying assumptions that are applied most frequently during the period;

(ii) disclosing any changes to the methods and, where a valuation technique is used, the assumptions[8] occurring during the period, together with the reasons for making the change(s), by class of financial instrument;

(iii) avoiding a *'same as last year'* approach towards the preparation of the fair value disclosures in future financial statements. The fair value disclosures in the annual financial statements should reflect the issuer's current circumstances. For example, disclosures are likely to require amendment in circumstances where a market for a financial instrument held becomes inactive, where there are movements in financial assets between Level 1, 2 and 3, where there are changes in the type or mix of financial assets held during the period or where there are changes in the valuation techniques selected by those charged with governance; and

(iv) where an issuer determines fair values by engaging the services of specialist pricing brokers, it is important to note that the directors of the entity remain responsible for determining the fair value of financial instruments. On that basis, those charged with governance must ensure that they understand, continue to carefully review, challenge and, as appropriate, reconsider the nature of the disclosures of the valuation methodologies and underlying assumptions in their annual financial reports.

[8] Only the most significant assumptions need to be disclosed. An assumption is considered significant where a change would have a significant impact on the fair value arising.

4 Risk disclosures

4.1 Introduction to risk disclosures

The ongoing global financial crisis, together with significant changes to the accounting standards concerning issuers' risk reporting, support the view that risk reporting has assumed greater significance to users of financial statements. Greater transparency regarding significant risks allows users to make more informed judgements regarding the key issues of risk and return.

4.2 Risk disclosures required by IFRS 7

The objective of IFRS 7 risk disclosures is to provide a wide range of users with information about the nature and extent of risks arising from financial instruments and how the entity manages those risks. It is to be expected, therefore, that issuers' financial instrument risk reporting will demonstrate their individual risk profile, how risks are managed, monitored, mitigated and any changes therein.

IFRS 7.33 and 7.34 requires disclosure for each type of risk. IFRS 7.6 provides that when disclosing information by 'class', they are grouped into classes that are appropriate to the nature of the information being disclosed, taking into account their characteristics. Financial instruments (e.g. notes issued by debt issuers) may be grouped into classes by: the nature/type of investments underpinning the notes, by type of note (asset backed/pass through notes, derivative/credit linked notes), by investment strategy, by currency or maturity date, or other defining characteristics.

4.3 Addressing the information needs of noteholders: debt issuers

Given that the objective of IFRS 7 is to provide users with information necessary to enable them to evaluate the nature and extent of risks arising from financial instruments, an assessment of who the users of the entity's financial statements are is of critical importance to determining appropriate risk disclosures.

In most instances, for example in the case of closed ended funds, the key users are the equity shareholders and potential shareholders. However, this is not usually the case in respect of most of the debt issuers coming within IAASA's review remit. A majority of these entities are typically structured as companies which are bankruptcy remote Special Purpose Entities ('SPE') which issue notes structured as limited recourse loans with the proceeds used to purchase investments. The share capital is typically held by charitable trusts or other nominees and equity shareholders often have no voting rights and no rights to participate in the profits, if any, of the company. Notes are usually issued in separate series, with the assets attributed to any particular series of notes held separately from those relating to any other series. These entities typically, and to varying degrees, alter the risk profile of each individual series of note by using derivatives to eliminate, or significantly reduce, the risks of the underlying collateral investments such that the holders of each series of note bear the remaining risks of ownership, i.e., the price risk of the underlying collateral assets. Gains and losses on investments are offset by losses and gains on the related series of note and on related derivative contracts. Thus, the company often bears no 'net' risk and is effectively profit neutral. Therefore, the key user of such issuers' financial reports is, in most instances, the current or potential noteholders, given that noteholders are the principal bearers of risks arising from investments and the main providers of finance to the company that issues the debt.

4.3.1 Aggregated v disaggregated risk disclosures

Where risks attached to notes or classes of notes with apparently different risk characteristics are disclosed in the annual financial reports on an aggregated basis[9], this may inhibit the ability of noteholders to determine the individual risks, or changes in risks, arising during the year relevant to each particular series or class of notes.

Furthermore, IFRS 7.33 and 7.34 requires the disclosure of each individual risk that makes up the overall risk exposure to financial instruments. Therefore, debt issuers that assert there is no overall 'net' risk must nonetheless disclose information for each individual risk arising from its exposure to financial instruments.

[9] This refers to the tendency of issuers to consolidate qualitative and quantitative risk disclosures at an overall portfolio of investments level rather than by class of financial instrument e.g. by class of note.

Given the diversified nature of the financial instruments that may underpin each note or class[10] of note, it is reasonable to expect that the risk disclosures adopted by debt issuers in their annual financial reports will reflect this diversity through appropriate classification and presentation of financial instruments and related risk disclosures by class of financial asset and financial liability.

4.3.2 Findings: Users of financial statements: debt issuers

All the debt issuers examined adopted a very narrow interpretation of users of the financial statements and limited their risk disclosures to those arising for the company's equity shareholders. One consequence of this was that debt issuers' reports failed to disclose some key risks borne by noteholders, for example, other price risk, credit risk, concentration risk and counterparty risk. An issuer that seeks to hedge currency risk, interest rate risk, and/or other price risk through, for example a total return swap will remain exposed to, at a minimum, counterparty risk.

Examples of disclosures indicative of debt issuers' focus on company risks rather than the wider body of users includes, for example:

> *'Any changes in the quoted prices or unquoted prices of any of the corporate bonds held by the Company would <u>not have any effect on the equity or profit or loss of the Company</u> as any fair value fluctuations are ultimately borne by either the swap counterparties or the holders of the debt securities issued by the Company'...* <u>[emphasis added].</u>
>
> *'The <u>Company's net exposure</u> to credit risk is minimal as the notes issued by it are limited recourse. Consequently any loss suffered on the investments held will reduce the amount which the Company is required to pay to the noteholders and therefore <u>does not result in a loss to the Company</u>.'* <u>[emphasis added].</u>

None of the sampled debt issuers' annual financial reports provided a clear description of the nature or shared characteristic that informed the directors' classification and presentation of risk disclosures in the annual financial report. All but one debt issuer provided key risk disclosures at an aggregated level (rather than disaggregated by class of note), notwithstanding indications of significant differences in the nature of financial instruments and, consequently, the risks underpinning different series of notes.

As mentioned above, this may negatively impact upon the ability of existing and potential noteholders to understand all the individual risks and changes in risks attaching to each class of note and hinder their ability to predict the future cash flows for each type of noteholder (i.e. the recoverability of the principal loan amount) and variability in its timing and certainty.

4.3.3 Recommendations: Improving risk disclosures for users: debt issuers

In preparing future annual financial reports those charged with governance of debt entities need to improve the quality of their risk disclosures. This can be achieved by:

(i) reflecting on the risks that the main users of the financial statements are exposed to, how each risk could impact the economic decisions taken by those users and how those risks are presented and disclosed in the annual financial report; in the case of debt issuers, recognising that the noteholders are a key user of the financial statements, being in most instances the principal source of finance;

(ii) avoiding the adoption of a '*same as last year*' approach to risk reporting or '*comparison to peer entities*', who may have different circumstances, risk profiles, strategies and/or poor disclosure policies;

(iii) reassessing, in respect of each reporting period, whether the annual financial report provides a comprehensive disclosure of all the risks and changes in risks that users of those reports may be exposed to and whether the risk disclosure provides information that is useful to those users' in making decisions.

[10] Paragraph 4.2 refers

(iv) ensuring that financial instruments[11] with dissimilar risk characteristics are not inappropriately aggregated for the purposes of risk disclosures. Noteholders must be able to appreciate the individual risk components of each class of note. The financial statements should provide a clear and concise description of the nature and characteristics shared by each class of note such that important differences between classes of notes are apparent to users of the annual report; and

(v) ensuring adequate disclosure of the judgements of those charged with governance regarding classification and presentation of investments and notes.

It is to be expected that future risk disclosures of debt issuers will reflect the diversity and complexity of the risk profile of the individual issuer and the financial instruments that it is exposed to rather than the commonalities of risk disclosures evident from many diverse debt issuers' annual reports to date.

4.4 Other price risk

The principal purpose of holding financial instruments, whether through closed ended funds or debt issuers that IAASA has within its remit, is to accrue capital gains from exposure to financial instruments, together with earning income on those instruments for the benefit of shareholders or noteholders. It follows, therefore, that users of their financial statements are particularly interested in information regarding risks of adverse changes in market prices. 'Other price risk' is the term used in IFRS 7 to describe such risks (other than those arising from interest rate risk or currency risk)[12].

4.4.1 Other price risk disclosures required by IFRS 7

IFRS 7.33 requires the disclosure, in qualitative terms, of information about exposures to risks, the objectives, policies and process for managing and measuring risk, as well as details of changes in those exposures or risk management methods in the period. IFRS 7.34 provides for summary quantitative data to be disclosed for each type of risk arising. Paragraph BC41 of IFRS 7 states that the requirements in paragraphs 33 to 42 combine qualitative disclosures, (of the entity's exposure to risks arising from financial instruments, and the way in which management views and manages these risks), with quantitative disclosures.

4.4.2 Findings: Other price risk disclosures

As is the case with some of the previously discussed disclosures, the most common failing in other price risk disclosures was the repetition of standard definitions of other price risk along with non-specific disclosures which lacked the information necessary to explain the components of other price risk particular to the entity or its financial instruments. In fact, there were very few genuine attempts to impart to the user an understanding of the specific nature of the other price risk arising from issuers' exposure to a particular mix or classes of financial instruments. Examples of poor quality and boilerplate other price risk disclosures include:

> *'The Fund is exposed to market price risk on all its investments.'*
>
> *'…market price risk relates to the....stock exchanges and to other exchanges, if any, where such investments are listed'.*
>
> *'The Company is exposed to market price risk arising from its investment in.......'*

These descriptions fail to enable users' to gain an understanding of the nature of other price risk contained in the financial assets or differences in other price risk in elements of the financial assets held.

Quantitative other price risk disclosure of fund issuers was found to be of better quality than that of debt issuers with data disclosed by class of investment in some cases (e.g. by asset type, class, listed/unlisted). A majority of the debt issuers had almost identical qualitative disclosures, indicative of the general failure to examine the other price risk specific to the issuer's investments and over time.

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[11] i.e. notes issued or the investments underpinning same

[12] IFRS 7, Appendix A defined other price risk as: *'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 or currency risk), 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.'*

Notwithstanding there being indications within other areas of the annual report of changes in other price risk during the year, a majority if issuers (11 out of 20) failed to clarify whether other price risk had changed during the period and, if so, why this had changed. For example, the following details were noted in certain issuers' reports, although there were no disclosures provided regarding changes in other price risk during the period:

- significant transfers between Level 2 and 3 prices indicating illiquidity of selected assets;
- changes in the proportion of listed and unlisted assets; and
- valuation details contained in the Directors' Report, Investment Manager's Report or in the notes to the financial statements.

4.4.3 Recommendations: Improving other price risk disclosures

In preparing future annual financial reports, those charged with governance of fund and debt entities need to improve the quality of their other price risk disclosures. This can be achieved by:

(i) going beyond generic and boilerplate qualitative disclosures of other price risk and providing users with a genuine understanding of the exposure to other price risk specific to the individual issuer's investments, why other price risk arises and why it differs for each significant class of investments and financial instruments;

(ii) ensuring disclosures continue to reflect changes, if any, in other price risk occurring during the year and explain the reasons (in qualitative and quantitative terms by class of investments) for those changes; and

(iii) avoiding the adoption of a '*same-as-last-year*' approach to other price risk disclosures. For example, enhanced disclosures should be considered when there is a significant movement in the hierarchy of fair value prices or where the relative proportions of the classes of investments have changed significantly (such as movements in relative holdings of equities, bonds, listed/ unlisted assets, rated/unrated assets, geographic spread of assets) which may be indicative of a change in the other price risk.

4.5 Credit risk

Whilst disclosures about credit risk are important for all issuers, they are critical for complex and structured debt issuers, whose business model is to package exposure to a set of risks, including other price and credit risks. In that regard, this section is of particular relevance to issuers of asset backed or derivative linked notes and, to a lesser extent, to closed ended funds where there is asset collateral or where derivatives are used.

4.5.1 Credit risk disclosures required by IFRS 7

In addition to the requirements of IFRS 7.33-34 in respect of all risks arising from financial instruments (and noted above), IFRS 7.36 states that an entity shall disclose, by class of financial instrument, the amount that best represents its maximum exposure to credit risk and include information about the credit quality of its financial assets.

4.5.2 Findings: Disclosure of credit risk

A majority of issuers' (11 out of 20) descriptions of their policies and processes for managing credit risk and the methods used to measure risk were generic and boilerplate statements, containing insufficient detail to inform users as to how risk is actually managed or how monitoring credit risk is applied in terms specific to the issuer. Examples of poor descriptions of credit risk policies and processes for managing credit risk included:

> *'Management have outsourced the responsibility of monitoring credit risk to....'* (without any reference to what these monitoring activities involve).
>
> *'The Company limits its exposure to credit risk by only investing with counterparties that have a credit rating defined in the documentation of relevant series'* (without any reference to who the counterparties are and what their credit rating or the concentration of same are).

A majority of debt issuers described the maximum exposure to credit risk by referring to the asset section of the Statement of Financial Position. However, debt issuers either failed to disclose the credit quality of financial assets or credit quality data was inappropriately aggregated. This hinders the ability of individual classes of noteholders to understand differences in risks by type of financial assets.

A majority of issuers failed to explain whether, and if so the reasons as to why, credit risk and the credit quality of assets changed during the period notwithstanding that in some cases issuers' quantitative disclosures indicated changes to credit risk had occurred. For example, changes in the percentage of listed investments, geographic concentration of assets or asset type or counterparty were frequently noted in issuers' financial reports.

4.5.3 Recommendations: Disclosure of credit risk – debt issuers

In preparing future annual financial reports, those charged with governance of debt entities need to improve the quality of their credit risk disclosures. This can be achieved by:

(i) providing a detailed explanation of the nature of the credit risk arising from the issuer's exposure to each class of financial instrument such that important differences in credit risks are not obscured or netted;

(ii) enhancing qualitative disclosures regarding the company's policies and processes for managing credit risk in a concise manner that gives more issuer specific detail, supplemented with quantitative data to illustrate practical application of the key policies/processes;

(iii) providing data about the credit quality of financial assets including by class of financial instrument or providing an explanation of why this has not been disclosed; and

(iv) ensuring that the credit risk notes continue to reflect changes, if any, in credit risk exposure of investments and provide explanations of the reasons for changes in the credit risk during the current period rather than merely reproducing last year's credit risk disclosures where this is not appropriate to the issuer's circumstances.

4.6 Counterparty risk

A concentration of, or overreliance on, a small number of counterparties or on counterparties with similar characteristics can expose an issuer to greater levels of credit risk in the event that those counterparties fail to honour their commitments.

4.6.1 Counterparty risk disclosures required by IFRS 7

IFRS 7.34(c) provides for the disclosure of quantitative data about concentrations of risk, including those arising from engaging with a limited number of individual counterparties. According to IFRS 7.B8, entities should disclose a description of how management determines concentrations, a description of the shared characteristic and also the amount of the associated risk exposure.

Paragraph IG18(d) states that:

> *'Paragraph 34 requires disclosure of quantitative data about concentrations of risk. For example, concentrations of credit risk may arise from:*
>
> *...a limited number of individual counterparties or groups of closely related counterparties.*

Paragraph IG16 states that:

> *'Information about the nature and extent of risks arising from financial instruments is more useful if it highlights **any relationship** between financial instruments that can **affect the amount, timing or uncertainty of an entity's future cash flows**. The extent to which a **risk exposure is altered by such relationships** might be apparent to users from the disclosures required by this Standard, but in some cases further disclosures might be useful'* [emphasis added].

4.6.2 Findings: Disclosure of counterparty risk

The counterparty risk exposure of the funds included in this review was observed as arising by virtue of counterparties' roles in acting as a custodian to cash, financial instruments and other such assets or providing a hedge to specific risks such as interest rate or currency risks through a variety of derivative instruments. The counterparty risk disclosures of these funds, while not without room for improvement, have been observed as of a higher quality in terms of relevant qualitative and quantitative disclosures, than that of debt issuers'. In particular, the qualitative disclosures of some debt issuers did not readily lend themselves to a reader of the financial statements understanding the nature of the counterparty risk and, if relevant, the associated concentration risk. Funds had, in most cases, identified the most significant counterparties. However, in a number of cases they failed to disclose information about the credit quality of counterparties.

There is greater potential exposure to counterparty risk in the case of derivative backed/credit linked notes as noteholders rely to a greater degree on counterparties' abilities to honour their commitments to provide income and a return of the principal amount borrowed, e.g. through the use of derivative instruments such as credit default swaps or total return swaps. Exposure to counterparty risk is increased further where there are a limited number of counterparties.

None of the debt issuers made explicit narrative reference to the concentration of counterparties and, in particular, derivative counterparties and/or why this fact gives rise to an elevated risk in the event of default of that counterparty. The derivative counterparty to total return swaps, credit linked swaps or equity swaps was in most cases a single counterparty and constituted a material percentage of total investments (in some cases 100% of the investments that underpin the notes issued by the debt entity), giving rise to an elevated risk in the event of default of that counterparty.

None of the debt issuers provided a sufficiently detailed explanation of the policies and processes used to manage the counterparty risk and the measurement of same. For example, there was not adequate disclosure of how the risk is monitored, whether this is by an independent service provider or other internal rating system, what criteria are monitored and how often data is communicated to the board.

Notwithstanding that 11 of 14 debt issuers had identified counterparties in the notes to the report (for example, for interest rate swaps, currency swaps, credit default contracts or total return swaps) the ability of users to put this information into context was limited because 9 out of 14 debt issuers did not clarify whether counterparty risk had changed during the period. Where a change in counterparty risk was evident, no debt issuer provided an explanation for the reasons for the change in the risk. 4 of 14 debt issuers failed to disclose the credit rating of some of their counterparties by omitting either the current or comparative credit rating of the counterparty.

4.6.3 Recommendations: Disclosure of counterparty risk

In preparing future annual financial reports, those charged with governance of funds and, in particular, debt entities need to improve the quality of their counterparty risk disclosures. This can be achieved by:

(i) providing clear disclosures of concentrations of counterparty risk, if any, along with the reasons why counterparty risk and concentrations thereof arises in terms specific to the issuer in question; such explanations should be qualitative/narrative and avoid general or standardised descriptions and identify the main counterparties, if necessary to enable users to understand the risk exposure;

(ii) quantifying the exposure to counterparty risk, for example using the credit rating of counterparties (or other measure of quality), including comparative data;

(iii) describing the policies chosen by the directors to measure, monitor and mitigate users' exposure to counterparty risk including changes therein, if any; and

(iv) giving details of any changes in counterparty risk, the reasons for those changes or state that there have not been any changes in same.

4.7 Management report

Given the volatile and uncertain nature of current market conditions, management reports must effectively communicate to users how the business has performed during the period, the current financial position of the entity (and changes that have occurred therein during the period) and likely future developments. Those charged with governance need to consider carefully the contents of their reports with a view to ensuring that they meet users' needs as well as complying fully with the relevant legislative provisions governing the minimum contents of same.

4.7.1 Content requirements in respect of the management report

In accordance with the provisions of the Transparency Regulations, Transparency Rules and company law[13], those charged with governance are required to prepare a management report (or a Directors' Report under Section 13 of the Companies (Amendment) Act, 1986) to accompany the annual financial statements, which must contain:

(i) a fair review of the development and performance of the business during the financial year and the position of the issuer at the reporting date; and

(ii) a description of the principal risks and uncertainties facing the issuer.

The management report should present a balanced and comprehensive analysis of the development and performance during the period and at year end, using key performance indicators (both financial and non-financial) where necessary. It should also give an indication of the issuer's likely future development, among other things.

4.7.2 Findings: Management report

Management reports of the surveyed issuers were in the main, boilerplate and generic, lacking any useful entity specific information and sufficient analysis necessary to understand the components of the overall performance for the financial period.

None of the surveyed debt issuers' management reports provided performance data by class of note, instead referring, in most instances, to the aggregated net profit or loss amount in the Statement of Comprehensive Income without any analysis of the basis for, or components of, that performance. The performance of each class of note (and underlying investments thereof) may differ and, therefore, for information to be useful to users, it is necessary to provide performance data at a more disaggregated level.

None of the surveyed debt issuers gave any indication of likely future developments or uncertainties. The following type of disclosures (considered vague and lacking in transparency) were not uncommon in debt issuers' annual reports:

> '*the directors expect that the present level of activity will be sustained for the foreseeable future…*'
>
> '*the directors do not envisage that there will be any substantial change for the foreseeable future in the operations of the Company…*'.

While there remains scope for improvement in the quality of funds' management reports, these were nevertheless found to be of a higher quality than those of debt issuers.

4.7.3 Recommendations: Management report - debt issuers

In preparing future annual financial reports, those charged with governance of fund and debt entities need to improve the quality of their management reports. This can be achieved by providing:

(i) an analysis of the performance of each class of notes in issue during the year that enables each class of noteholder to understand the performance, financial position and likely future cash flows. This should explain the basis for the performance rather than being limited to a mere reference to the absolute amount; and

[13] Regulation 5(4)(c)(ii) of the Transparency (Directive 2004/109/EC) Regulations 2007, Rule 6.1 of the Transparency Rules of the Central Bank, September, 2009 and Section 13 of the Companies (Amendment) Act, 1986.

(ii) the thoughts and rationale of those charged with governance as to likely future developments and uncertainties that may affect the future returns for each class of noteholder.

In the current volatile and uncertain market conditions, it is to be expected that those charged with governance would give a renewed focus to the ways in which they can effectively communicate how the business, and key components thereof, have performed during the period, the entity's financial position and likely future developments (including uncertainties) that, in the directors' view, may impact upon the future returns to users.