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## Are your AASB 7: Financial Instruments Disclosures Ready for Scrutiny? At Least Three Good Reasons to Get Them Right:

### 1. Commercial

The current economic environment means that credit is not as readily available as it might have been 12 or even 6 months ago.

Our experience indicates that banks and other financial institutions are carefully managing their own risks, and will show preference in their lending practices to entities that produce transparent financial reports, with good disclosures about how financial instrument risks are managed.

In this environment, current market conditions combined with the new disclosure requirements mean that AASB 7 disclosures are likely to be closely scrutinised by regulators, auditors and others. Entities can expect attention from shareholders and other market participants as the disclosures will be an excellent source of information on financial risk exposures and how they are managed.

### 2. ASX Corporate Governance Principles and Recommendations- 2<sup>nd</sup> Edition

The Principles of Good Corporate Governance and Best Practice Recommendations were originally issued in March 2003 and were revised by the ASX Corporate Governance Council and released on 2 August 2007 as '**Corporate Governance Principles and Recommendations – 2<sup>nd</sup> Edition**'. The revised principles have application for financial years commencing on or after 1 January 2008. For further details on these principles, please refer to the PKF September 2008 edition of Corporate Edge at:

<http://www.pkf.com.au/NewsAndPublications/Newsletters/Newsletters/Corporate%20Edge%20Sep%202008.pdf>

Under Principle 7: *Recognise and Manage Risk*, it is made clear that material business risks involve both financial and non-financial risks. Companies are encouraged to adopt appropriate risk oversight, management policies and internal control systems rather than disclose specific material business risks.

Recommendation 7.3 contains a revised version of the existing "assurance" or "sign-off" on financial reporting risks. The Recommendation requires the board to disclose that it has received assurance from the CEO/CFO, that the declaration under section 295A of the Corporations Act is founded on a sound system of risk management and internal control which is operating effectively in all material respects in relation to financial reporting risks. This means that entities cannot just treat this as a disclosure issue.

In preparing disclosures required under AASB 7, entities may identify new risks, or risks that are being managed in a different way to established formal policies...

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Boards of directors and management therefore need to ensure that they have developed, documented and implemented risk management objectives and strategies that are appropriate for their operations and exposures. In theory, under AASB 7, the disclosures should depend on the way management manages financial risks and on the extent of use of financial instruments. However in practice, the principle of “through the eyes of management” is reflected primarily in the qualitative description. Some of the quantitative disclosures are very precisely set out in the standard and may therefore not reflect the way management actually looks at the risk.

The AASB 7 disclosure requirements can present a Corporate Governance challenge.

### 3. ASIC Surveillance

The Australian Securities and Investments Commission (“ASIC”) have issued guidance to entities preparing their 31 December 2008 financial reports. The guidance specifically highlights shortcomings with regard to AASB 7 disclosures or lack thereof in 30 June 2008 financial statements reviewed by them under their financial reporting surveillance programme. The full results of this review can be viewed on ASIC’s website at the following link

<http://www.asic.gov.au/asic/asic.nsf/byheadline/08-218+ASIC+review+of+30+June+2008+reports+and+areas+of+focus+for+upcoming+reporting+period?openDocument>

ASIC has drawn attention in their guidance, to other matters that will receive specific attention for 31 December 2008 financial reporting. These areas include, going concern, impairment of assets, determining fair values and off balance sheet arrangements.

#### What Are the Challenges of preparing AASB 7 Disclosures?

When it comes to AASB disclosures, it is clear that one size does not fit all. The significance of an entity’s financial instruments and the nature and extent of risks arising from those financial instruments will vary from industry to industry and from entity to entity. This means that disclosures made will need to be tailored to the unique circumstances of each entity. The financial statements should tell a story of how management responds to identified risks and what is truly going on within the entity.

Illustrative model financial reports are a useful guide, however the most inappropriate response to dealing with AASB 7 disclosure requirements is to simply turn to these boiler plate disclosures, particularly where they clearly bear no relation to the entity’s financial instrument risks and financial instruments risk management.

AASB 7 is a ‘principles based standard’ that offers broad parameters and limited guidance, leaving the detailed application to individual entities. The result is that substantial judgement is required in ascertaining the appropriate disclosures. There could be many interpretative issues upon which the board and management need to decide – from simple decisions such as the level of aggregation and time bands disclosed, to complex issues about how to interpret the requirements around the various quantitative and qualitative disclosures.

The disclosures in AASB 7 should be formed *through the eyes of management*, that is they should closely align to internal risk reports. This is a source of information that could be helpful in telling what has really taken place in the company during the year, particularly in the current climate. Users of the financial statements will expect information about how entities identify and respond to risks, and how they ensure that appropriate risk management policies and procedures are in place.

In light of the current focus on credit quality, exposure to financial and other risks, increased caution with regard to how the disclosures are presented in the financial statements is warranted. Entities need to ensure that the disclosures are comprehensive and informative and present an accurate picture of an entity’s financial instruments. Voluntary disclosure of additional information may be necessary. Disclosures that may require particular attention include the liquidity analysis, market risks that are unhedged or managed with complex derivatives. Care also needs to be taken so that sufficient explanation is provided where risks are internally managed in a different way relative to quantitative disclosures required under AASB 7.

Complying with AASB 7 means more than just getting disclosures right. AASB 7 disclosures require a great deal of detailed information gathering and analysis, which can be time-consuming and laborious. A number of the mandatory disclosures necessitate sometimes complex calculations, judgement and information gathering. Many entities may not necessarily have systems in place from which all the required disclosures can be obtained and information provided by counterparties such as banks and other financial institutions is unlikely to be sufficient to meet the extensive disclosures required by AASB 7.

The preparation of the disclosures must allow sufficient time for this information to be obtained. Applying AASB 7 affords an excellent opportunity to reassess the manner in which risks are identified and managed within the organisation.

### In summary

Volatile markets and economic uncertainty make it even more critical that companies carefully manage risk, in particular financial instruments risk, and are able to demonstrate this to stakeholders through transparent disclosure and evidence of meaningful compliance with AASB 7.

PKF are able to provide guidance on compliance with AASB 7 and Corporate Governance Principles & Recommendations in a workshop format with your finance personnel, or finance team.

Should you require assistance or additional information, please contact your Engagement Partner or:

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