



A Guide to Sections 3862, Financial Instruments – Disclosures & 1535, Capital Disclosures



BDO Dunwoody LLP
Chartered Accountants
and Advisors

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1 Introduction to Sections 3862, Financial Instruments Disclosures & 1535, Capital Disclosures

All entities, irrespective of the sector in which they operate and the size of their business will, to some extent, have financial assets and financial liabilities. Whether these are in the simple form of trade receivables, trade payables, cash and bank overdrafts, or more complex instruments such as forward exchange contracts or interest rate swaps, these financial assets and financial liabilities will expose the entity to risk. In order to give greater transparency regarding those risks and allow users of financial statements to make more informed judgements about risk and return, Section 3862 will require entities to provide enhanced disclosures about their use of financial instruments. Section 3862 is substantially converged with IFRS 7, Financial Instruments – Disclosures. Section 3862 along with Section 3863, Financial Instruments – Presentation replace Section 3861, Financial Instruments – Presentation and Disclosure. Section 3863 carries forward the presentation requirements of Section 3861 unchanged.

As well as incorporating many of the disclosures about the significance of financial instruments for an entity's financial position and performance previously contained in Section 3861, Section 3862 also requires information about the extent to which an entity is exposed to risks arising from financial instruments, the nature of those risks and a description of management's objectives, policies and processes for dealing with them. Together, these disclosures are intended to provide an overview of the entity's use of financial instruments and the exposures to risks they create.

The related Section 1535, which is converged with the capital disclosure requirements of IAS 1, Presentation of Financial Statements, requires an entity to provide information about the level of capital it employs and its objectives, policies and processes for managing that capital. The reasons for introducing the new Section 1535 were two-fold:

- (a) disclosures about capital should be required because the level of an entity's capital and how it manages capital are important factors for users to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events, and because the level of capital might also affect the entity's ability to pay dividends; and
- (b) all entities should be required to disclose information about capital, regardless of whether they are subject to external capital requirements, because such information is useful for all entities (as is evidenced by the fact that some entities set internal capital requirements and norms have been established for some industries) and users of their general purpose financial statements.

Both Section 3862 and Section 1535 adopt, subject to certain minimum disclosure requirements, a management's perspective approach. This means that the level and nature of the disclosures given by an entity will be dependent not only on the risks to which that particular entity is exposed, but also the ways in which that entity's management address those risks.

2 Scope of this Publication

This publication is intended to provide practical guidance on the application of Sections 3862 and 1535. It provides an illustrative example of the type of disclosures that might be given by a manufacturing company.

The example is intended to illustrate the disclosures that might be appropriate for this type of entity and, as a consequence the example does not show all of the disclosures that might also be required. Example disclosures for some of these additional items have been included within the body of this publication.

When considering the illustrative example in this publication, it should be considered that the application of the management's perspective approach may result in entities exposed to substantially similar risks providing very different but equally acceptable disclosures, particularly in terms of the structure of the information provided. Entities should ensure that the disclosures made are specific to their own circumstances, the actual risks they face, their own policies and their own management information. 'Boiler plate', templated narrative descriptions and the inclusion of information that is not specific to the individual company in both accounting policies and other disclosures, can lead to misleading and incomplete information for the users.

3 Applicability and Transitional Provisions

3.1 Applicability

Sections 3862 and 1535 are applicable to all entities that have adopted the new financial instrument recognition and measurement sections, and they are applicable for interim and annual financial statements beginning on or after October 1, 2007. For a calendar year end, the first interim period impacted was March 31, 2008 and the first annual period impacted is December 31, 2008.

Section 3862 is applicable to *all* financial instruments except:

- those interests in subsidiaries, entities subject to significant influence, and joint ventures that are accounted for in accordance with Sections 1590, Subsidiaries, 3051, Investments, or 3055, Interests In Joint Ventures, and those variable interests in variable interest entities that are consolidated in accordance with Accounting Guideline AcG-15, Consolidation of Variable Interest Entities.

However, entities shall apply Section 3862 to derivatives with an underlying that is based on such an interest unless the derivative meets the definition of an equity instrument in Section 3855, Financial Instruments – Recognition and Measurement;

- employers' rights and obligations arising from employee benefit plans, to which Section 3461, Employee Future Benefits, applies;
- contracts for contingent consideration in a business combination (see Section 1581, Business Combinations). This exemption applies only to the acquirer;
- financial instruments, contracts and obligations under stock-based payment transactions to which Section 3870, Stock-Based Compensation and Other Stock-Based Payments, applies, except that Section 3862 applies to contracts within the scope of paragraphs 3855.14 -.17; and
- pension obligations of defined benefit pension plans, to which Section 4100, Pension Plans, applies.

Section 3862 applies to recognized and unrecognized financial instruments. Recognized financial instruments include financial assets and financial liabilities that are within the scope of Section 3855, Financial Instruments – Recognition and Measurement. Unrecognized financial instruments include some financial instruments that, although outside the scope of Section 3855, are within the scope of Section 3862 (such as some loan commitments).

Section 3862 applies to contracts to buy or sell a non-financial item that are within the scope of Section 3855 (see paragraphs 3855.14-.17).

For entities eligible to use Section 1300, Differential Reporting, certain exemptions from the requirements exist. These will be discussed later in the publication.

3.2 Comparative Information

Comparative information for the disclosures required in Section 3862 about the nature and extent of risks arising from financial instruments is not required in the year the Section is adopted.

4 Location, Level and Format of Disclosures

4.1 Level and complexity of disclosure

The standard aims to provide some flexibility in respect of the level and complexity of the disclosures given by an entity; it is clear that, subject to certain minimum disclosures, the level of information provided should be consistent with an entity's specific circumstances. Paragraph B3 of Section 3862's application guidance notes that:

“An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Section, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.”

As a broad principle, when making decisions regarding the level and nature of the disclosures to be given, an entity should consider both the qualitative and quantitative materiality of the information.

The flexibility of the standard is further demonstrated in the implementation guidance, which notes that not all of the information suggested in that section of the standard need be reproduced by an entity, if it is not considered appropriate, but also that it may be appropriate to disclose other information not required or suggested by the standard in other circumstances^(Section 3862.IG5 & IG6A). There is no equivalent flexibility in respect of the disclosures described in the main body of the standard or in the application guidance in Appendix B.

4.2 Format of Disclosures – The Management's Perspective Approach

The standard adopts a management's perspective approach to the format of the disclosures it requires. This is particularly the case in the disclosures on nature and extent of risks arising from financial instruments.

This approach is implicit for the qualitative disclosures, as the standard is not prescriptive about the format of disclosures that must be given, and explicit for the quantitative disclosures, through the requirement that disclosures are *based upon* the information provided to the entity's Key Management Personnel.¹

Where Key Management Personnel use several methods to manage a risk exposure, the entity need not disclose information regarding each method; the standard requires that only the most relevant and reliable information be provided^(Section 3862.B7). This concession is clearly a practical necessity without which an entity might be forced to reproduce large volumes of summarised management information.

This concession does, however, also present management with some potentially difficult judgments regarding what information should be presented. Such decisions are extremely specific to the reporting entity and it is therefore not possible to provide specific guidance on this requirement; the standard refers the reader to the relevance and reliability guidance in Section 1000. In our view the disclosures given should be based upon the information on which Key Management Personnel places most of the emphasis during their decision making process.

The information presented in the financial statements should also be in a format that is consistent from year-to-year unless there has been a justifiable and permanent shift in the information used by management, in which case the reason for the change should be explained.

While the standard bases its guidance on applying the management's perspective approach to the quantitative risk disclosures, it is equally useful when deciding upon the nature and structure of the qualitative risk disclosures, as these should reflect the risks to which Key Management Personnel consider the entity is exposed, and the objectives, policies and processes that they rely on the most to address those risks.

The disclosures in respect of the significance of financial instruments for financial position and performance are much more prescriptive and, as a consequence, there is less scope for the management's perspective approach other than in the allocation of financial assets and financial liabilities to classes.

¹ Section 3840.04(d) – Key Management Personnel are any person(s) having authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. (In the case of a company, management would include the directors, officers and other persons fulfilling a senior management function. When an independent committee of the board of directors is established in accordance with regulatory requirements, to represent the non-controlling interests of an enterprise, the directors serving on that committee are deemed not to be related parties for the transaction under consideration.)

5 Nature and Classes of Financial Instruments

This Section applies to recognized and unrecognized financial instruments. Recognized financial instruments include financial assets and liabilities that are within the scope of Section 3855. Unrecognized financial instruments include some financial instruments that, although outside of the scope of Section 3855, are within the scope of Section 3862. For example, some loan commitments are within the scope of Section 3862 because the arrangement still gives rise to a financial liability in the issuer, as it is a contractual obligation to deliver cash or another financial asset to another entity, and a financial asset in the party that has the right to draw on those funds.

Where settlement date accounting is adopted for regular way sales and purchases of financial assets for the period between the trade date and the settlement date, an unrecognized financial liability will exist in the seller (i.e. an obligation to deliver the financial asset to the purchaser) and an unrecognized financial asset in the purchaser (i.e. the right to receive the financial asset from the seller). In both cases, as a financial asset or liability exists, the arrangement falls within the scope of Section 3862.

5.1 Classes of Financial Instrument

In many places, Section 3862 requires disclosures to be provided by **class** of financial instrument. The application guidance accompanying the standard makes clear that the **classes** referred to are determined by the entity and that they need not be the same as the **categories** specified in Section 3855 ^(Section 3862.B1) although, as a minimum, an entity must distinguish between instruments measured at amortized cost and those measured at fair value and must not aggregate financial instruments outside of the scope of Section 3862 with those which are within its scope ^(Section 3862.B2). Where the classes of financial instruments are different from those specified in Section 3855, Section 3862.06 requires the entity to provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

The application and implementation guidance also deals with allocating financial instruments to a particular class. The application guidance stipulates that the classes should be appropriate to the nature of the information disclosed and take into account the characteristics of those financial instruments ^(Section 3862.B1). The guidance on credit risk disclosures goes further and indicates that financial instruments in the same class would be expected to share economic characteristics with respect to the risk being disclosed ^(Section 3862.IG21). It is clear from this that a particular financial instrument might be included in several different classes depending on the aim of the disclosure in question.

For instance, a bank might split its loans into classes such as residential mortgages, unsecured consumer loans and commercial loans for the purposes of its credit risk disclosures but analyze the same instruments into classes such as Canadian dollar and US dollar denominated loans for the purposes of its market / currency risk disclosures.

Financial assets and financial liabilities should not be offset within a class unless they meet the offset conditions set out in paragraph 3863.26.

6 Disclosures on the Significance of Financial Instruments for Financial Position and Performance

Section 3862 requires disclosures that serve two main purposes:

- the disclosure of the significance of financial instruments to the entity's position and performance; and
- the disclosure of qualitative and quantitative information about the exposure to risks arising from financial instruments.

The disclosures of the significance of financial instruments is the combination of the balance sheet, income statement, equity and other disclosures which enable users to assess how financial instruments have affected an entity's financial position and performance in the current period.

6.1 Balance Sheet Disclosures

6.1.1 Categories of Financial Assets and Financial Liabilities

In order to assist users in understanding the extent to which accounting policies affect the amounts at which financial assets and financial liabilities are recognized, the carrying amounts of each of the following **categories** of financial instrument, as defined in Section 3855, must be disclosed either on the face of the balance sheet or in the notes to the financial statements ^(Section 3862.08):

- a) financial assets designated as held for trading upon initial recognition;
- b) financial assets that meet the criteria for held for trading per Section 3855;
- c) held-to-maturity investments;
- d) loans and receivables;
- e) available-for-sale financial assets;
- f) financial liabilities designated as held for trading upon initial recognition;
- g) financial liabilities that meet the criteria for held for trading per Section 3855; and
- h) financial liabilities measured at amortized cost.

The separate analysis for financial instruments designated as at held for trading upon initial recognition and those that meet the criteria to be classified as held for trading in accordance with Section 3855 is useful because such designation is at the discretion of the entity.

Although derivative financial instruments that are designated as hedging instruments are excluded from the above mentioned categories, they should still be included in this analysis for the sake of completeness.

6.1.2 Financial Assets Designated as Held for Trading

Where an entity has designated a loan or receivable (or group of loans or receivables) as held for trading, the standard requires the following disclosures to be presented ^(Section 3862.09).

- a) the maximum exposure to credit risk of the loan or receivable (or group of loans or receivables) at the reporting date;
- b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk;
- c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
 - i. as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (i.e. effectively all changes other than those caused by credit risk); or
 - ii. using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

- d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

In addition, the standard requires the disclosure of the methods used to comply with the requirements in point (c) above and, if the entity believes that the information it has disclosed in order to comply with the requirements in point (c) above, does not faithfully represent the change in the fair value of the financial asset attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant (Section 3862.11)

The requirement in point (a) above may seem, at first glance, to be a duplication of the maximum credit risk disclosure requirement in paragraph 3862.36(a), but this may not necessarily be the case. The requirement is for information specifically in respect of Section 3855 defined loans and receivables **category** whereas paragraph 3862.36(a) requires an analysis of maximum credit risk by **class** of financial instrument. For the purposes of Section 3862 disclosures, an entity's management must use their own judgement in identifying classes of financial instruments and assigning financial assets and financial liabilities to those classes, and that a class of financial instrument need not necessarily correspond to a Section 3855 **category**. However, where the classes selected by management do correspond with the categories specified in Section 3855, the information need not be duplicated in the financial statements. Indeed, this principle is made clear in the implementation guidance where it is noted that, in practice, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement (Section 3862.IG2)

The standard does not provide specific guidance on how to calculate maximum credit risk for a loan and receivable designated as held for trading; should it be equal to the carrying value (i.e. the maximum loss that would be reflected in the income statement) or the maximum cash loss that could be suffered by the entity if the counterparty defaults? While Section 3862 is not specific, and therefore permits an entity to disclose the information that is considered by management to be most relevant to the entity's circumstances, other requirements of the standard suggest that the carrying value should be disclosed. For example:

- this disclosure requirement is in the section of the standard that aims to provide the reader with information on the significance of financial instruments for financial position and performance. The measurement of maximum credit risk as being the asset's carrying value best represents the potential effect of credit risk on the income statement and the balance sheet presented;
- the other requirements within this section of the standard are based on changes in fair value which would have been reflected in the income statement. Given this, it would be inconsistent to calculate the maximum credit risk on any other basis than carrying value; and

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- the application guidance states that (when measuring credit risk for the purposes of the disclosures on the nature and extent of risks arising from financial instruments) the maximum exposure to credit risk is the carrying amount of the related loan and receivable; the same is true for the maximum exposure to credit risk of derivative contracts. It would be inconsistent to suggest that the maximum cash loss method should be used for the disclosures on the significance of financial instruments for financial position and performance.

In addition, to be consistent with the credit risk disclosure requirements later in the standard, it is our view that these disclosures should not take into account collateral held or other credit enhancements.

6.1.3 Financial Liabilities Designated as Held for Trading

Section 3855 permits entities to designate a non-derivative financial liability as held for trading if certain conditions are met. One idiosyncrasy of this treatment is where an entity elects to fair value its issued debt; a deterioration in its own credit rating will, all other factors being constant, give rise to a gain being reported in its income statement. In order to prevent a misinterpretation of such an income statement credit, where an entity has designated a financial liability as held for trading, Section 3862 requires the following disclosures to be presented ^(Section 3862.10):

- a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability; and
- b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

Like the requirements for loans and receivables designated as held for trading, Section 3862 allows the amount of change in value to be determined either as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (i.e. effectively all changes other than those caused by credit risk) or by using an alternative method that more faithfully represents the amount of change attributable to changes in the credit risk of the financial liability.

If an alternative method is deemed more appropriate, the reasons for reaching this conclusion and the factors the entity believes are relevant must be disclosed along with a description of the method adopted ^(Section 3862.11).

An example of how point (a) above can be applied (using the method specified in the standard) is included in the application and implementation guidance of the standard (see paragraphs 3862.B4 & IG7-11).

An illustrative example of the disclosures required by the standard is shown in Figure 1.

Figure 1

Financial Liabilities as Held for Trading

On 1 January 2007, the Group issued a \$150,000 bond which matures on 31 December 2017 which it has designated as held for trading.

The fair value of the bond at 31 December 2007 is \$153,811² and of the change in fair value during the year of \$3,811, \$1,444 is attributable to changes in the credit risk of the bond (cumulatively \$1,444)³. The amount attributable to changes in credit risk has been calculated by estimating the amount of change in fair value that cannot be attributed to changes in market risk⁴.

The bond's carrying amount is \$3,811 greater than the amount that the Group is contractually required to pay at maturity to the holder of the obligation⁵.

The example in Figure 1 assumes that changes in fair value arising from factors other than changes in the instruments credit risk and changes in interest rates are not significant. If the bond in the example contained, for instance, an embedded derivative, the calculation should have excluded any change in fair value of the embedded derivative when determining the amount attributable to changes in credit risk (Section 3862.B4).

Other changes in market conditions that might give rise to market risk include the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature (e.g. a feature that links the contract to an identified asset or pool of assets), changes in market conditions include changes in the performance of the related asset. (Section 3862.10(a)).

6.1.4 Derecognition

Under Section 3862, an entity may transfer financial assets in such a way that part or all of those assets do not qualify for derecognition. (Section 3862.13A)

The standard requires the following disclosures:

- a) the nature of the assets;
- b) the nature of the risks and rewards of ownership to which the entity remains exposed; and
- c) the carrying amounts of the assets.

² Section 3862.08(e)

³ Section 3862.10(a)(i)

⁴ Section 3862.11(a)

⁵ Section 3862.10(b)

Note that this disclosure requirement is by **class** of financial asset, not by Section 3855 **category**.

6.1.5 Collateral

Collateral Pledged by the Entity – Financial Assets

Where the entity has pledged some of its own *financial* assets as collateral for liabilities or contingent liabilities, it must disclose ^(Section 3862.14):

- a) the carrying amount of financial assets it has pledged; and
- b) the terms and conditions relating to its pledge.

These disclosures must be given for all financial assets pledged as collateral, including those that have been separately disclosed because the recipient of the collateral has the right by contract or custom to sell or re-pledge it.

In our view, only significant terms and conditions need be disclosed. These might include:

- the nature of the assets pledged and whether they can be replaced by other assets;
- whether a decrease in the fair value of the collateral pledged (e.g. a loss in value on an equity security) would give rise to an obligation to provide additional collateral to the counterparty;
- who holds the collateral (the counterparty or a third party) and how it is held (e.g. in escrow); and
- where the recipient of the collateral has the right to sell or re-pledge the assets, that fact, and what assets the entity can demand back at the end of the collateral agreement.

Collateral Held by the Entity – Financial and Non-financial Assets

Where the entity holds assets as collateral and is permitted to sell or re-pledge it in the absence of a default by the counterparty, it must disclose ^(Section 3862.15):

- a) the fair value of the collateral held;
- b) the fair value of any such collateral sold or re-pledged, and whether the entity has an obligation to return it; and
- c) the terms and conditions associated with its use of the collateral.

It should be noted that, unlike the disclosures in respect of collateral pledged by an entity, these disclosures are for both financial *and* non-financial assets held as collateral.

Where an entity considers credit risk to be a material risk, further disclosures are required of the nature and extent of risks arising from the financial instruments. These disclosures are in respect of all collateral held, irrespective of whether the entity is permitted to sell or re-pledge it in the absence of a default by the counterparty.

6.1.6 Allowance Account for Credit Losses

For each **class** of asset, where an entity records impairments in a separate account (i.e. use of allowance account) rather than by directly reducing the carrying amount of the asset, the standard requires the disclosure of a reconciliation of changes in that account in the period ^(Section 3862.16).

The format of this reconciliation is not specified by the standard, allowing entities flexibility in determining the most appropriate format for their needs.

In our view, disclosing only the net change as a reconciling item would not be acceptable as it would fail to provide sufficient information to enable users to assess the adequacy of the impairment allowance.

6.1.7 Compound Financial Instruments with Multiple Embedded Derivatives

If an entity has issued an instrument that contains both a liability and an equity component and that instrument also has multiple embedded derivatives whose values are interdependent, it is required to disclose the existence of those features ^(Section 3862.17).

Section 3855 requires the separation of the liability and equity components of a compound financial instrument. Where a financial instrument contains multiple embedded derivative features whose values are interdependent (e.g. a callable convertible debt instrument of a Canadian functional currency entity denominated in Canadian Dollars with interest based on US Dollar LIBOR and featuring a separable prepayment penalty) the calculations involved in determining the fair value of the various components can be complex and, if the embedded equity and non-equity derivative features are interdependent, the sum of the separately determined fair values of the liability, embedded derivative, and equity components will not equal the fair value of the compound financial instrument as a whole. As a consequence, it is important that the existence of such instruments and their principal terms are highlighted to the reader of the financial statements.

6.1.8 Defaults and Breaches on Loans Payable

The final balance sheet disclosures required in respect of the significance of financial instruments for financial position and performance are for loans payable, which the standard defines as ‘financial liabilities, other than short-term trade payables on normal credit terms’ ^(Section 3862.05A).

While the standard does not define ‘short-term trade payables on normal credit terms’, in our view, in the use of the term ‘short-term trade payables’ the standard is seeking to exclude financial liabilities that are incurred as part of the entity’s normal operating cycle that are expected to be settled in that cycle.

The disclosures required by the standard in respect of such instruments are^(Section 3862.18),

- a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
- b) the carrying amount of the loans payable in default at the reporting date; and
- c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorized for issue.

It should be noted that requirement (a) is for the disclosure of all defaults that occurred during the period, not only for those defaults that still exist at the balance sheet date.

If, during the period, there were breaches of loan agreement terms other than those described previously, an entity is required to disclose the same information as specified if those breaches permitted the lender to demand accelerated repayment. However, in this case, the information need only be disclosed if the breaches were not remedied, or the terms of the loan were not renegotiated, on or before the reporting date^(Section 3862.19).

Where breaches or defaults have occurred in the year, the impact of these events on the current / non-current presentation of the loans payable should be considered in the light of the requirements of Section 1510, Current Assets and Current Liabilities.^(Section 3862.1G12)

6.2 Income Statement and Equity Disclosures

The standard requires an entity to provide an analysis of financial income, expense, gains or losses.^(Section 3862.20) The analysis is intended to facilitate an understanding of the financial performance of the entity’s financial instruments given the different measurement bases required or allowed under Section 3855.

In order to achieve this objective, the standard requires the disclosure, on the face of the income statement or in the notes, of the net income or expenses recognized on ^{(3862.20(a))}:

- a) financial assets or financial liabilities designated as held for trading upon initial recognition;
- b) financial assets or financial liabilities classified as held for trading in accordance with Section 3855;
- c) held-to-maturity investments;
- d) loans and receivables;
- e) financial liabilities measured at amortized cost; and
- f) net gains and losses on available for sale financial assets which have been removed from equity and recognized in profit or loss for the period;

The standard also requires disclosure of the total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not classified as held for trading ^{(Section 3862.20(b))}.

Section 3862 also requires the separate analysis, on the face of the income statement or in the notes, of ^{(Section 3862.20(c)-20(e))}:

- a) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
 - i. financial assets or financial liabilities that are not classified as held for trading; and
 - ii. trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.
- b) interest income on impaired financial assets accrued in accordance with Section 3025, Impaired Loans; and
- c) the amount of any impairment loss for each **class** of financial asset.

Unlike the analysis of movements in impairment provisions, the disclosure required by point (c) must be given irrespective of whether the impairment loss is recorded in a separate account or directly against the asset. Consequently, whilst these two disclosure requirements may be combined, entities should not assume that compliance with the requirements described in section [6.1.6](#) means they have complied with all of the standard's requirements in respect of impairment losses on financial assets.

Finally, the standard requires the disclosure, on the face of the statement of changes in equity / statement of comprehensive income, or in the notes, of the net gains and losses on available-for-sale financial assets recognized directly in other comprehensive income during the period ^{(Section 3862.20(a)(ii))}.

As previously noted, derivative financial instruments that are designated as hedging instruments are excluded from the definition of an asset held for trading and, as a consequence, gains and losses on such instruments are not included within the scope of these income statement and equity disclosures.

6.3 Other Disclosures – Accounting Policies

General

Section 1505, Disclosure of Accounting Policies, requires an entity to disclose significant accounting policies. Section 3862 provides, in its application guidance, an indication of the information that should be presented in respect of financial instruments ^(Section 3862.B5). In our view, this represents a minimum level of disclosure that must, where it is relevant to the entity, be presented. Additional accounting policies as well as indications of the significant judgements that management has made in selecting appropriate accounting policies will also need to be given in order to fully comply with the requirements of Section 1505 and Section 1400, General Standards on Financial Statement Presentation.

A number of the requirements noted within Section 3862 call for the disclosure of the criteria that have been met in order to treat a certain transaction or balance in a certain way. For example, the criteria for designating financial assets or financial liabilities as held for trading. We do not believe that a general ‘boiler plate’ description of the criteria contained within the relevant standard would be sufficient; the disclosures should reflect the judgements made by the entity in respect of specific classes of financial asset or financial liability.

Financial Assets and Financial Liabilities Designated as Held for Trading

The standard requires the disclosure of the nature of the financial assets or financial liabilities the entity has designated as held for trading on initial recognition and the criteria for so designating those financial instruments. ^{(Section 3862.B5(a)(i)-(ii))}

Financial Assets Designated as Available for Sale

Section 3855 allows assets that would otherwise have been categorised as held to maturity or loans and receivables to be designated as available for sale. Where an entity does this, a description of the criteria used in designating financial assets as available for sale should be given ^{(Section 3862.B5(b))}.

Determination of Net Gains and Losses

The standard requires the disclosure of how net gains or net losses on each Section 3855 **category** of financial instrument are determined, for example, whether the net gains or net losses on items classified as held for trading include interest or dividend income ^{(Section 3862.B5(e))}.

Allowance Accounts, Impairments and Renegotiations

The standard also requires the disclosure of the criteria used to determine that there is objective evidence that an impairment loss has occurred.

When an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses, the standard requires disclosure of:^{(Section 3862.B5(d))}

- i. the criteria for determining when the carrying amount of impaired financial assets is reduced directly and when the allowance account is used; and
- ii. the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets.

When the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the summary of accounting policies should include a policy for financial assets that are the subject of renegotiated terms^{(Section 3862.B5(g))}. In particular, this should include how the entity determines whether debt assets have been renegotiated to such an extent that they represent a new instrument or simply a modification in the terms of the original debt.

Regular Way Purchases and Sales

Finally, the standard requires the entity to disclose whether regular way purchases and sales of financial assets⁶ are accounted for at trade date or at settlement date^{(Section 3862.B5(c))}.

6.4 Other Disclosures – Fair Value

Accounting policy choices made by an entity will have a significant affect on the financial statements, and many of the disclosure requirements of Section 3862 are designed to clarify the effect that a certain accounting policy choice has had on the financial statements. The fair value information required by the standard is intended to promote a greater comparability between entities where different accounting policies have been adopted for similar instruments. It also permits comparison of financial instruments within an entity that have substantially the same economic characteristics, regardless of why they are held and when, and by whom they were issued or acquired.

The standard requires disclosure of the fair values of financial assets and financial liabilities in a way that permits comparison with their carrying amounts. These disclosures should be provided for each **class** of financial asset and financial liability^(Section 3862.25).

⁶ Section 3855.19(n) - defines a regular way purchase or sale of a financial asset as one where the contract terms require delivery of the asset within a time frame established by regulation or convention in the marketplace concerned.

A fair value must be disclosed for all financial assets and financial liabilities except for (Section 3862.29),

- a) those whose carrying amount is a reasonable approximation of fair value (e.g. financial instruments such as short-term trade receivables and payables);
- b) investments in equity instruments that do not have a quoted market price in an active market, other than such instruments that are classified as held for trading, and for derivatives that are linked to and must be settled by delivery of equity instruments of another entity whose fair value cannot be reliably measured - such instruments and derivatives are measured at cost in accordance with Section 3855;
- c) financial assets or financial liabilities transferred or originated in a related party transaction that are classified as held-to-maturity investments, loans or receivables, or financial liabilities other than ones held for trading; or
- d) actuarial liabilities of life insurance enterprises, to which Accounting Guideline AcG-8, Actuarial Liabilities of Life Insurance Enterprises — Disclosure, applies.

For those financial instruments that fall in to category's (b) to (d), the standard requires additional disclosures that will help readers make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value. As a minimum, these disclosures must include:

- a) the fact that fair value information has not been disclosed for these instruments, either because of the unavailability of a quoted market price in an active market or because their fair value cannot be measured reliably;
- b) a description of the financial instruments, their carrying amount, and if the reason for measuring the instruments at cost is because fair value cannot be measured reliably, an explanation of why fair value cannot be measured reliably;
- c) information about the market for the instruments;
- d) information about whether and how the entity intends to dispose of the financial instruments; and
- e) if financial assets previously required to be measured at cost in accordance with Section 3855 are derecognized, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognized.

For loans secured by related parties, for which an entity has not received separate quotes for the interest rate on a loan with and without the collateral, it is unlikely that the entity will be able to determine reliably the rate that would have been charged for such a loan in the absence of the collateral. Section 3855.A40, specifies that, in such circumstances, the entity uses the interest rate on such a loan as if it was a market rate of interest and measures it on initial recognition at its face amount, adjusted, if appropriate, for transaction costs. In disclosing the fair value of such a loan, an entity may continue to use the interest rate on such a loan without adjusting for the effects of the collateral.

However, the entity would adjust the disclosed value of the loan for other factors, including, but not limited to, changes in general market rates of interest, changes in credit risk, etc..

As well as the quantitative fair value disclosures, the standard also requires a description of the methods used to determine the fair value of financial assets and financial liabilities. In particular, it requires the disclosure of ^(Section 3862.27):

- a) the methods and, when a valuation technique is used, the assumptions applied in determining the fair values of each **class** of financial asset or financial liability. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses and interest rates or discount rates;
- b) whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique;
- c) whether the fair values recognized or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data; and
- d) if (c) applies, the total amount of the change in fair value estimated using such a valuation technique that was recognized in profit or loss during the period.

If, when calculating the fair value of a financial asset or financial liability using a valuation technique, changing one or more of the assumptions used in the valuation model to other reasonably possible alternative assumptions would change the fair value *significantly*, that fact should be disclosed along with the effect of those changes ^{(Section 3862.27(c))}.

For the purposes of the sensitivity disclosure, significance is judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognized in equity, total equity ^{(Section 3862.27(c))}. Through the reference to significance, the standard is seeking to limit the complexity and quantity of disclosure that would otherwise result from this requirement; this is confirmed in the basis for conclusions to IFRS 7 where it is stated that detailed quantitative disclosure of sensitivity to all assumptions is not required and that there is no requirement to reflect interdependencies between assumptions when making the disclosure.

If the market for a financial instrument is not active, Section 3855 requires an entity to establish its fair value using a valuation technique. Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e. the fair value of the consideration given or received). It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity must disclose, by **class** of financial instrument ^(Section 3862.28).

- a) its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph 3855.A50); and
- b) the aggregate difference yet to be recognized in net income at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

Paragraph 3862.IG14 provides an example of the disclosures required by paragraph 3862.28.

7 Disclosures on Nature and Extent of Risks Arising from Financial Instruments

This section considers the disclosure requirements covering the nature and extent of risks arising from financial instruments.

7.1 Categories of Risk

Section 3862 requires both qualitative and quantitative disclosures that, together, will provide users with information about the risks arising from financial instruments and the techniques used to identify, measure, monitor and control those risks.

The standard identifies three categories ^(Section 3862.32) of risk to which most entities using financial instruments will, to a greater or lesser extent, be exposed ^(Section 3862.05A):

- credit risk – the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge its obligation;
- liquidity risk – the risk that an entity will encounter difficulty in meeting obligations associated with its financial liabilities; and
- 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 is analyzed in to a further three subcategories:

- interest rate risk – the risk that the fair value or future cash flows of financial instruments will fluctuate because of changes in market interest rates. It arises on interest-bearing financial instruments recognized in the balance sheet (e.g. loans and receivables and debt instruments issued) and on some financial instruments not recognized in the balance sheet (e.g. some loan commitments)^(Section 3862.B22);
- currency risk (or foreign exchange risk) – the risk that the fair value or future cash flows of financial instruments will fluctuate because of changes in foreign exchange rates. It arises on financial instruments that are denominated in a currency other than the functional currency in which they are measured but does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency of the entity^(Section 3862.B23); and
- other price risk – the risk that the fair value or future cash flows of financial instruments 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 an individual financial instrument or its issuer, or factors affecting similar financial instruments traded in the market. Other price risk may include equity price risk, commodity price risk, prepayment risk (i.e. the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (e.g. a lessor of an automobile that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing market risk include, but are not limited to^(Section 3862.IG32):
 - the yield curve of market interest rates,. (It may be necessary to consider both parallel and non-parallel shifts in the yield curve);
 - foreign exchange rates;
 - prices of equity instruments; and
 - market prices of commodities.

The standard requires both qualitative and quantities disclosures to be given.

7.2 Qualitative Disclosures

The standard requires qualitative disclosures to be given that, for each type of risk arising from financial instruments, describe ^(Section 3862.33):

- a) the exposures to risk and how they arise;
- b) the entity's 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.

We have already mentioned the management's perspective approach adopted by the standard and its flexibility in terms of the structure and extent of the information provided; the qualitative risk disclosure requirements of the standard is an area in which this is particularly evident. The only guidance on how to apply these requirements in practice, other than the general guidance on the categories of risk and classes of financial instrument and level of disclosure, is contained in three paragraphs in the implementation guidance. In particular, paragraph 3862.IG15 suggests that an entity might choose to disclose:

- a) the entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions;
- b) the entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:
 - i) the structure and organization of the entity's risk management function(s), including a discussion of independence and accountability;
 - ii) the scope and nature of the entity's risk reporting or measurement systems;
 - iii) the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and
 - iv) the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.
- c) the entity's policies and procedures for avoiding excessive concentrations of risk.

Using a trade receivable denominated in a currency other than the entity's functional currency as an example, a 'risk transfer transaction' might be the use of non-recourse debt factoring, whereby a third party takes on all of the risk associated with that receivable. The use of forward exchange contracts would be an example of a 'risk mitigation transaction'; in this case an entity is still exposed to credit risk but it has mitigated the currency risk on the receivable by accepting an equal and opposite currency risk on the forward exchange contract. The implementation guidance in paragraph 3862.IG15(a) suggests that, in this example, credit and currency risk should still be discussed notwithstanding that the entity's risk management policies have mitigated or negated those risks.

As well as the qualitative disclosures which are based on management's view of risks faced by the entity, in the section of the standard dealing primarily with quantitative risk disclosures, further specific qualitative information (discussed in the following three sections) is required covering concentration of risk, credit risk and liquidity risk. These must be given when the entity has a material concentration of risk or a material exposure to credit or liquidity risk.

7.2.1 Concentration of Risk

Concentrations of risk arise from groups of financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions^(Section 3862.B8). As an example, a concentration of credit risk may arise if an entity transacts with a limited number of individual counterparties or groups of closely related counterparties or transacts with counterparties that are concentrated in one or more^{(Section 3862.IG18(a)-(d))}.

- industry sectors;
- credit qualities (such as secured or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade); or
- geographical markets (whether they are groups of countries, individual countries or regions within countries).

Similar principles apply to identifying concentrations of other risks. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market to realize liquid assets. Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or an aggregate net open position in several currencies that tend to move together^(Section 3862.IG18).

The identification of risk concentrations requires management to exercise judgement as the standard gives no percentage test or other 'bright line' against which potential concentrations can be measured. In our view, material concentrations of risk will usually be evident from the analysis provided in reports used by Key Management Personnel and that these reports should form the basis on which disclosable concentrations are identified.

Paragraph 3862.34(c) requires, where the information is not apparent from the quantitative disclosures presented, an entity to provide disclosures about the concentrations of risk within each overall risk category. In practice, a certain degree of additional qualitative disclosure is likely to be required in order to comply with the application guidance contained within the standard which requires:

- a description of how management determines concentrations of risk; and
- a description of the shared characteristic that identifies each concentration.

The standard also requires some quantitative disclosures regarding concentration of risk.

7.2.2 Credit Risk – Collateral or Other Credit Enhancements

Where an entity considers credit risk to be material, it must disclose a description of any collateral held as security against financial assets held at the reporting date^{(Section 3862.36(b))}; this information must be separately disclosed for any financial assets that are past due or impaired^{(Section 3862.37(c))}. The standard suggests that the description might include^(Section 3862.1G22):

- the policies and processes for valuing and managing collateral;
- a description of the main types of collateral held;
- the main types of counterparties to collateral and their creditworthiness; and
- information about risk concentrations within the collateral.

Where an entity obtains a financial or non-financial asset during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g. guarantees or netting agreements that do not qualify for offset under Section 3863), and these assets are recognized in the financial statements, the entity must disclose the nature and carrying amount of the assets obtained and, when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations^(Section 3862.38). The objective of this disclosure is to provide information about the frequency of such activities and the entity's ability to obtain and realize the value of collateral and, in consequence, there is no requirement to link the disclosure to specific defaults.

In addition to the disclosures just described, which are based upon conditions at the balance sheet date, where the disclosures given are unrepresentative of the entity's exposure to risk during the period, additional disclosures that are representative should be provided^(Section 3862.35).

The standard also requires quantitative disclosures on collateral or other credit enhancements both in terms of the significance of financial instruments on the position and performance and the nature and extent of risks arising from financial instruments.

7.2.3 Liquidity Risk

Where an entity considers liquidity risk to be material, the entity must disclose how it manages the liquidity risk that arises from balance sheet financial liabilities maturing over time^{(Section 3862.39(a))}. The standard suggests that the description might include whether the entity^(Section 3862.IG31):

- expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for on-demand customer deposits placed with a bank);
- expects some of its undrawn loan commitments not to be drawn;
- holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs;
- has committed borrowing facilities (e.g. commercial paper facilities) or other lines of credit (e.g. stand-by credit facilities) that it can access to meet liquidity needs;
- holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities;
- holds deposits at central banks to meet liquidity needs;
- has very diverse funding sources; or
- has significant concentrations of liquidity risk in either its assets or its funding sources.

In addition to the disclosures described, which are based upon conditions at the balance sheet date, where the disclosures given are unrepresentative of the entity's exposure to risk during the period, additional disclosures that are representative should be provided^(Section 3862.35).

7.3 Quantitative Disclosures

In addition to the qualitative information presented, Section 3862 also requires the disclosure of quantitative information about its exposure to each type of risk reported as at the balance sheet date.

Like the qualitative disclosures, the standard requires the quantitative information presented to reflect management's view of the risks that are faced by the entity and, to achieve this, the disclosures given should be *based* on the information provided internally to the entity's Key Management Personnel.

For liquidity risk in particular, the requirement to base the disclosures on information provided internally to the entity's Key Management Personnel may require the disclosure of some sensitive information. For example, for a company with significant liquidity risk due to low levels of working capital, a summary cash flow forecast may be appropriate. While there appears to be no option other than to disclose such potentially sensitive information (for instance, there is no exemption from the requirement if management consider it to be seriously prejudicial to the company), the fact that the requirement is for the disclosure to be based on this information, means that there is some scope for summarising the information used by management. An entity may be able to summarise information in such a way as to present a fair view of the liquidity risk it faces whilst not disclosing information that might prejudice its operations.

Like the qualitative disclosures, the standard also requires a minimum level of specific quantitative disclosure in respect of material risks^{(Section 3862.34(b))} irrespective of the nature of information used by Key Management Personnel. In our view, where Key Management Personnel considers a particular risk category (e.g. credit risk) to be material to the entity, all of the minimum disclosures specified should be presented; it cannot select only some of the minimum disclosures and omit the others. As discussed, materiality needs to be considered from both a quantitative and qualitative perspective and should take into account the needs of all users of the financial statements.

The combination of the minimum disclosures and the management's perspective disclosures is intended to strike a balance between consistency and comparability between entities on one hand, and practicality and entity specificity on the other.

The disclosures must be as at the balance sheet date but, to the extent that the data is unrepresentative of the entity's exposure during the period, further information that is representative (e.g. the highest, lowest and average amount of risk to which the entity was exposed during the period or a graph showing the changes in risk exposure during the year) should be presented^(Section 3862.35). The requirement to disclose balance sheet information relevant to the period as a whole, rather than simply at a snapshot date, is a significant departure from past practice and it would be advisable for entities to assess the potential effect at an early stage and to take steps to address any potential problems that may arise. For example, say a loan covenant requires an entity to ensure that its ratio of current assets to current liabilities is greater than 1.5:1 at the balance sheet date and, although the entity achieves this target at the balance sheet date, on average during the year the ratio is 1.4:1. These disclosures may result in the lender reconsidering the nature of the covenants it sets if it has not been consulted and an agreement reached prior to the publication of the financial statements.

7.3.1 Concentration of Risk

The standard also requires, where the information is not apparent from the other quantitative disclosures presented, the disclosure of information that highlights the amount of the risk exposure associated with all financial instruments sharing that risk concentration characteristic^{(Section 3862.34(c) & B8(c))}. This means that if all financial instruments within a particular class are part of the same risk concentration, then no further disclosure will be necessary whereas where a class of financial instruments is drawn from two or more risk concentrations, a sub-analysis will be required. For instance, where an entity considers corporate bonds to be a class of financial instrument and all of those bonds are denominated in the entity's functional currency, there would be no need to provide additional analysis in respect of currency risk. However, if a significant proportion of the portfolio were bonds denominated in another currency, that class would have to be sub-analyzed to illustrate the different concentrations of currency risk within that class. In practice, the existence of concentrations of risk can make quantitative risk disclosures extensive and complex.

7.3.2 Credit Risk – Minimum Disclosures

Maximum Exposure to Credit Risk

The standard requires all entities that consider credit risk to be material^{(Section 3862.34(b))} to disclose, by **class** of financial instrument, 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 (e.g. netting agreements that do not qualify for offset in accordance with Section 3863 should be disclosed gross)^{(Section 3862.36(a))}. This information is useful as it highlights to readers of the financial statements, situations where the maximum exposure might differ from the amount recognized in the balance sheet. Such a situation might arise, for example, where an entity issues a financial guarantee to a bank. This disclosure requirement is not necessarily a duplication of the maximum credit risk disclosure as one requirement is by **class** of financial instrument and the other is by Section 3855 **category**.

For most financial assets (e.g. loans and receivables, deposits placed with other entities and derivative contracts measured at fair value) the maximum exposure to credit risk will typically be the gross carrying amount net of any amounts offset in accordance with Section 3863 and any impairment losses recognized^(Section 3862.B9). However, the entity's specific circumstances should be taken into consideration when this decision is made.

Where an entity issues a financial guarantee contract, it will be exposed to credit risk because it will suffer if one party to that financial instrument causes a financial loss for another party by failing to discharge its obligations. The fact that the entity neither lends nor receives the cash is irrelevant. The maximum exposure disclosed by the guarantor will be the full amount guaranteed^{(Section 3862.B10(c))} (including any undrawn committed facilities that cannot be settled net in cash) despite the fact that the amount recognized in its financial statements is likely be a financial liability of a lesser amount.

Similarly, the maximum exposure to credit risk from an irrevocable loan commitment that cannot be settled net in cash or another financial asset will be the maximum amount that can be demanded by the counterparty to the arrangement irrespective of the amount that was drawn down at the balance sheet date^{(Section 3862.B10(d))}.

Financial Assets that are Either Past Due or Impaired

A financial asset is past due when the counterparty to that asset has failed to make a payment when it is contractually due^{(Section 3862.05A (h))}; it is not necessarily the same as it being impaired as the counterparty may settle its obligation at a future date. Where the terms of an instrument have been renegotiated, it is those renegotiated terms which should be considered when assessing whether the instrument is past due or impaired^(Section 3862.IG27).

The standard requires the following disclosures to be given when an entity considers credit risk to be material^{(Section 3862.34(b))}:

- a) an analysis of the age of each **class** of financial assets that are past due as at the reporting date but not impaired^{(Section 3862.37(a))}. The time bandings used in this disclosure should be consistent with those used in the information provided to the entity's Key Management Personnel.

The standard requires this disclosure as it provides users with information about those financial assets that are more likely to become impaired and helps users to estimate the level of future impairment losses. Like the requirement to disclose variations of risk over the year, entities are advised to consider the potential impact of this disclosure requirement as it may give rise to some unwelcome results.

Take, for example, an entity that gives 30-day credit terms but that operates in a sector where other, longer terms are the standard practice. In this case, the entity is likely to have a significant percentage of its trade receivables classified as past due despite the fact that its customers are simply adhering to the industry norm, whereas, another entity identical except that their standard credit terms match the industry norm will disclose significantly fewer past due financial assets.

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- b) an analysis, by **class** of financial asset, of those that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired^{(Section 3862.37(b))} (such as the age of the asset and the geographical location or nature of the counterparty).

This requirement will not result in the disclosure of each individual impaired asset. The analysis should be in aggregate for each class of asset and factor that gave rise to the impairment; the aim of the disclosure is to help the reader understand why the impairments have occurred.

The standard also requires, unless impracticable, an estimate of the fair value of any collateral held in respect of financial assets that are either past due or impaired^{(Section 3862.37(c))}. A description of collateral held by the entity as security and other credit enhancements in respect of the amounts disclosed in (a) and (b) above is also required.

Further disclosures in respect of collateral held which the entity has the right to sell or repledge is required in the disclosures covering the significance of financial instruments for financial position and performance.

Credit Quality and Renegotiated Terms

Where an entity assesses credit risk as material^{(Section 3862.34(b))}, the standard requires the disclosure of:

- a) the disclosure of information about the credit quality of financial assets that are neither past due nor impaired^{(Section 3862.36(c))}.
- b) the carrying amount of financial assets that, had their terms not been renegotiated (e.g. payment terms changed or collateral provided), would be past due or impaired^{(Section 3862.36(d))}; and

The information is intended to provide the reader of the financial statements with a greater insight into the credit risk of certain assets and help users to assess whether assets are more or less likely to become impaired in the future. Because such information will vary considerably between entities, the guidance is contained within the implementation guidance which suggests that the following might be included^(Section 3862.IG23):

- a) an analysis of credit exposures using an external or internal credit grading system;
- b) the nature of the counterparty;
- c) historical information about counterparty default rates; and
- d) any other information used to assess credit quality.

When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about^(Section 3862.IG24):

- a) the amounts of credit exposures for each external credit grade;
- b) the rating agencies used;
- c) the amount of an entity's rated and unrated credit exposures; and
- d) the relationship between internal and external ratings.

When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about^(Section 3862.IG25):

- a) the internal credit ratings process;
- b) the amounts of credit exposures for each internal credit grade; and
- c) the relationship between internal and external ratings.

7.3.3 Liquidity Risk – Minimum Disclosures

The standard requires disclosure, when an entity considers liquidity risk material^{(Section 3862.34(b))}, of an analysis of financial liabilities that shows their remaining contractual maturities^{(Section 3862.39(a))}.

As with the aged analysis of financial assets, there is no standard time banding mandated by the standard; they should be consistent with those used in the information provided to the entity's Key Management Personnel^(Section 3862.B11). However, where these bandings do not adequately reflect the liquidity risk faced by the entity, these bandings should be sub-analyzed so that the risk exposure is properly disclosed. For example, if management have a banding of 'later than one month and not later than three months' and a significant loan repayment is due in just over one month, consideration should be given to further analysing this category in the financial statements. It may also be the case, particularly for smaller entities, that the time bandings used in the management accounts are insufficiently detailed for the purposes of the disclosures in the financial statements.

All payments due in respect of a financial liability should be included in the time band appropriate for the earliest date at which the counterparty could demand it^(Section 3862.B12-13). For a financial institution, this would include the disclosure of the maximum facility available under an undrawn loan commitment as payable on demand, if that is appropriate for the terms agreed on the facility. Conversely, for the corporate counterparty, the value of liquidity risk disclosed would be limited to the amount actually drawn down on the facility analyzed in the appropriate time band for when the bank can demand repayment.

Similarly, for a financial institution, the balances on in-credit current accounts will be disclosed as payable on demand whereas a corporate counterparty would only be *required* to disclose this information for overdraft facilities that have no agreed term (and so could be repayable on demand) and do not qualify for offset under Section 3863.

The standard requires that the amounts disclosed in the maturity analysis are the contractual undiscounted cash flows. Such undiscounted cash flows will differ from the amounts included in the balance sheet, which will be based on discounted cash flows. It provides the following examples^(Section 3862.B14):

- a) gross capital 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 (e.g. a currency swap) for which gross cash flows are exchanged; and
- e) gross loan commitments.

It is clear from these examples that the analysis must include the interest obligations associated with the financial liability, calculated as if that liability was settled at the earliest possible date (e.g. accrued interest payable on overdraft facilities that are repayable on demand will be shown in the current time banding).

When the amount payable is not fixed, the standard requires the amount disclosed to be determined by reference to the conditions existing at the reporting date^(Section 3862.B16). The example in paragraph B16 of the application guidance suggests that, where 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. In our view, the use of the word ‘may’ in this example suggests that an alternative to the precise index might be acceptable. For instance, the disclosure of the interest payments on a floating rate loan could be based either on the current rate or the expected rates at the balance sheet date, although the latter method is likely to become complex if the entity has long-term financial liabilities. We believe that this principle can also be applied to obligations that must be settled in a foreign currency; the disclosures should be in the entity’s presentational currency and translated at the balance sheet date exchange rate or forward rate. Whichever approach an entity adopts, it must be applied consistently to all financial instruments in the liquidity analysis and consistently from period to period. It may also be appropriate to include an accounting policy, particularly if the difference would be material to the disclosure.

Where appropriate, the maturity analysis of derivative financial instruments should be disclosed separately from that of non-derivative financial instruments.

One condition that might make this appropriate is where the cash flows arising from the derivative financial instruments are settled gross; this is because the gross cash outflow may be accompanied by a related inflow ^(Section 3862.B15).

Finally, the standard suggests that, if an entity manages liquidity risk on the basis of expected maturity dates, it might disclose a maturity analysis of the expected maturity dates of both financial liabilities and financial assets ^(Section 3862.IG30). If the entity chooses to make this disclosure, it must be in addition to the mandatory disclosures described in this section and the disclosure should make it clear that it is based on estimates made by management, explain how the estimates are determined and the principal reasons for differences from the contractual maturity analysis that is required by application guidance.

For example, a financial institution may manage its liquidity risk on the assumption that credit balances in current accounts which are legally repayable on demand will not be withdrawn either immediately or simultaneously; in such cases it would be appropriate for it to provide an *additional* analysis of maturities as long as the basis for the alternative analysis is clearly explained.

7.3.4 Market Risk – Minimum Disclosures

General Considerations

Many users of financial statements consider a sensitivity analysis to be fundamentally important, and, as a result, Section 3862 requires all entities that have material exposure to one or more sub-category of market risk ^{(Section 3862.34(b))} to present one for each type of market risk to which it is exposed.

Where an entity prepares a sensitivity analysis, such as value at risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, Section 3862 allows that entity to present sensitivity information based on that alternative method of analysis ^(Section 3862.41). For other entities, the standard provides guidance on the method of calculating and disclosing sensitivities that must be applied. Although, for entities that use their own alternative method, the standard implies a choice between the nature of the information that it discloses, our view is that they should disclose information based on the alternative method, as to do otherwise would be at odds with the management's perspective approach adopted by the standard.

Irrespective of which method is adopted by an entity, when it considers the resulting information to be unrepresentative of a risk inherent in a financial instrument, it must disclose that fact and the reason it believes the sensitivity analysis are unrepresentative ^(Section 3862.42).

Such situations can arise when:

- a) a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, e.g. options that remain out of (or in) the money for the chosen change in the risk variable^(Section 3862.IG37);

In such situations additional disclosure might include: The terms and conditions of the financial instrument (e.g. the options); the effect on profit or loss if the terms or conditions were met (i.e. if the options were exercised); and, a description (if appropriate) of how the risk is hedged or otherwise mitigated^(Section 3862.IG38).

- b) financial assets are illiquid (e.g. when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty^(Section 3862.IG37)). In such cases, additional disclosure might include the reasons for the lack of liquidity and how (if it does so) the entity hedges or otherwise mitigates the risk^(Section 3862.IG39);

- c) an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding^(Section 3862.IG37). In such situations additional disclosure might include: the nature of the security (e.g. entity name); the extent of holding (e.g. 15 per cent of the issued shares); the effect on profit or loss; and, how (if it does so) the entity hedges or otherwise mitigates the risk^(Section 3862.IG40); and

- d) an entity hedges its net investment in a foreign operation with either a derivative or non-derivative financial instrument. Whereas the hedging instruments are included in the market risk disclosures, the hedged item (the net investment) will not be, as it is not a financial instrument. In such cases an entity might include additional disclosures that show how the hedging arrangement means that the effect on equity of the hedging instrument's sensitivity is reduced due to offsetting movements in the value of the hedged item.

Sensitivity Analysis – Specified Method

An entity that does not use an alternative sensitivity analysis method must present sensitivity analysis for each type of market risk to which it is exposed at the reporting date. This analysis must show how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date^{(Section 3862.40(a))}.

‘Reasonably Possible’ Change

The standard provides guidance on how to determine boundaries for changes in variables for the purposes of the sensitivity analysis.

However, it stops short of quantifying specific parameters for a ‘reasonably possible’ change in a relevant risk variable because, although it would result in more comparable information, what is ‘reasonably possible’ would change from entity to entity and for each type of risk. As a result, entities are required to judge what those reasonably possible changes are considering the economic environment in which they operate^{(Section 3862.B19(a))}. A reasonably possible change can be expressed in absolute or percentage terms but, whichever approach is adopted, it should be used consistently from year to year.

When determining what the reasonably possible change in a relevant risk variable might be, the entity should only consider the timeframe up until it next presents these disclosures^{(Section 3862.B19(b))}. Although it is not specified in the standard, we do not believe that the disclosure of Section 3862 compliant sensitivity information in an entity’s interim financial report would be sufficient to justify a shortening of the timeframe used in the immediately preceding year-end to determine the reasonably possible change.

Other price risk arises from changes in market prices 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. As a consequence, where an entity holds a diversified portfolio of equity investments the extent of change that it considers to be its reasonably possible change might be lower than if it held investments in only one entity because entity specific fluctuations would be less significant in the context of the portfolio as a whole.

A reasonably possible change should not include remote or ‘worst case’ scenarios or ‘stress tests’^{(Section 3862.B19(a))}. In addition, the disclosure should only reflect the effect on profit or loss and equity at the limits of the range determined, not for intervals within that range^{(Section 3862.B18(b))}.

Finally, a change in the underlying risk variable during a reporting period would not necessarily lead to the need for a recalculation of the reasonably possible future change in value at the reporting period end unless the entity considers that the variable has become significantly more volatile^{(Section 3862.B19(a))}. For example, say an entity deems the reasonably possible change in interest rates to be 1 per cent for the purposes of its market risk sensitivity disclosures in its 2006 annual financial statements. If, during 2007 interest rates increase by 1.5 per cent but the economic environment remains substantially unchanged, it would be acceptable for the entity to continue to deem the reasonably possible change to be 1 per cent in its 2007 financial statement disclosures. However, if the economic environment has changed in the intervening period, the reasonably possible change will have to be reassessed irrespective of the accuracy of the prediction in the prior year.

Effect on Profit or Loss and Equity

The disclosure is only required to show the effect on profit or loss and equity of changes in the relevant risk variable that were reasonably possible at the reporting date; entities are not required to determine what profit or loss for the period would have been if the relevant risk variables had been different^{(Section 3862.B18(a))}. This means that the analysis must be applied only to instruments that were in existence at the balance sheet date using their value at that date, regardless of whether this is representative of the overall exposure to market risk during the period. As explained above, the standard requires further disclosures if the sensitivity analysis provided is considered to be unrepresentative of the entity's exposure to market risk during the period.

Although it is not referred to specifically in the standard, our view is that the effect should be calculated on a post-tax basis as illustrated in the example provided in the implementation guidance^(Section 3862.IG36).

Some examples of how the requirement described is applied to financial instruments whose fair values or future cash flows might fluctuate due to changes in market prices and affect profit or loss or equity are shown in Table 1.

Table 1

Instrument	Element Affected	Sensitivity	Profit or Loss or Equity?	Calculation
Floating rate functional currency denominated debt	Interest	Interest rate risk	Profit or loss	Year end balance multiplied by the reasonably possible interest rate variation gives the reasonably possible effect of sensitivity.
Floating rate foreign currency denominated debt	Carrying value	Currency risk	Profit or loss	Balance sheet date exchange rate is adjusted by the reasonably possible rate variation to give an adjusted rate. An adjusted carrying amount is calculated using the adjusted rate. The difference between the actual and adjusted carrying amount is the reasonably possible effect of sensitivity.

Floating rate foreign currency denominated debt	Interest	Currency risk	Profit or loss	<p>Base interest is calculated by applying the balance sheet interest rate to the balance sheet carrying amount of debt.</p> <p>Balance sheet date exchange rate is adjusted by the reasonably possible rate variation to give an adjusted rate.</p> <p>The difference between base interest translated at the balance sheet exchange rate and that translated by the adjusted rate is the reasonably possible effect of sensitivity.</p>
Equity investments designated as held for trading	Carrying value	Other price risk (equity prices)	Profit or loss	<p>Balance sheet date equity price is adjusted by the reasonably possible equity price variation to give an adjusted price.</p> <p>The difference between carrying value based on the actual and adjusted equity price is the reasonably possible effect of sensitivity.</p>
Equity investments designated as available for sale	Carrying value	Other price risk (equity prices)	Equity ⁷	<p>Balance sheet date equity price is adjusted by the reasonably possible equity price variation to give an adjusted price.</p> <p>The difference between carrying value based on the actual and adjusted equity price is the reasonably possible effect of sensitivity.</p>

⁷ Note: It is possible that there may also be an effect on profit or loss where the value used in the sensitivity analysis would give rise to an impairment of the available for sale asset.

Forward exchange contracts used as cash flow hedging instruments	Carrying value	Currency risk	Equity ⁸	Balance sheet date forward exchange rate is adjusted by the reasonably possible exchange rate variation to give an adjusted rate. An adjusted fair value is calculated using the adjusted exchange rate. The difference between the actual and adjusted fair value is the reasonably possible effect of sensitivity.
Fixed rate debt held at amortized cost	Carrying value and interest	Interest rate risk	Neither	Changes in interest rates would not have an effect on profit or loss or equity.
Fixed rate debt denominated in the functional currency of a foreign subsidiary and held at amortized cost	Carrying value	Currency risk	Neither	Translation exposures arise from financial instruments that are denominated in a currency other than the functional currency in which they are measured. Translation exposures arising from the translation in to a presentational currency are not taken into account.

Relevant Risk Variable

The standard requires the disclosure of sensitivity information for all financial instruments used within the entity's business and for all market risks that it is exposed to ^(Section 3862.B21).

Example

An example of the application of the principles described is shown in Figure 2.

Figure 2

An entity, whose functional currency is Canadian Dollars (\$CAD), takes out a US Dollar (\$USD) denominated variable rate loan on the first day of its accounting period. The loan is held at amortized cost. Interest was calculated and paid on a quarterly basis and a capital repayment was made at the end of the third quarter as shown below:

⁸ Note: There will also be an effect on profit or loss where the hedge is not 100 percent effective.

	Inception \$USD	Q1 \$USD	Q2 \$USD	Q3 \$USD	Q4 \$USD	Year end \$USD
Capital repayments		-	-	(50,000)	-	(50,000)
Principal	100,000	100,000	100,000	50,000	50,000	50,000
Interest payments		(1,500)	(1,563)	(1,563)	(812)	(5,438)
		Q1	Q2	Q3	Q4	Average
Interest rate		6.00%	6.25%	6.25%	6.50%	6.25%

The exchange rate fluctuations during the year had the following effect:

	Inception \$CAD	Q1 \$CAD	Q2 \$CAD	Q3 \$CAD	Q4 \$CAD	Year end \$CAD
Capital repayments		-	-	(34,482)	-	(34,482)
Principal	66,667	68,965	71,428	34,482	34,482	34,482
Exchange differences		2,298	2,464	(2,464)	-	(2,298)
Interest payments		(1,035)	(1,116)	(1,078)	(560)	(3,789)
	Inception	Q1	Q2	Q3	Q4	Average
Exchange	1.50	1.45	1.40	1.45	1.45	1.45

The entity determines that the reasonably possible changes in the relevant risk variable at the balance sheet date are:

- interest rates: 1%;
- foreign exchange: 10%; and
- the entity receives a tax deduction of 30% on interest paid and exchange gains and losses.

Disclosures in the entity's financial statements might be as follows:

Interest Rate Risk

The annualised affect of a 1% decrease in the interest rate at the balance sheet date on the variable rate debt carried at that date would, all other variables held constant, have resulted in an increase in post-tax profit for the year of \$CAD 241⁹. A 1% increase in the interest rate would, on the same basis, have decreased post-tax profit by the same amount.

However, because the Group made a substantial loan repayment during the year, the directors consider a more representative measure of the Group's interest rate risk exposure during the year would be obtained by applying the same principles to the weighted average outstanding loan balance during the year of \$USD 87,500. On this basis the annualised affect of a 1% increase / decrease in the interest rate at the balance sheet date would have resulted in a decrease / increase in post-tax profit for the year of \$CAD 422¹⁰.

Foreign Exchange Risk

The affect of a 10% strengthening of the US Dollar against the Canadian Dollar at the balance sheet date on the US Dollar denominated debt carried at that date and the annual interest incurred on that amount would, all other variables held constant, have resulted in an decrease in post-tax profit for the year of \$CAD 2,856¹¹. A 10% weakening in the exchange rate would, on the same basis, have increased post-tax profit by \$ CAD 2,335.

However, because the Group made a substantial loan repayment during the year, the directors consider a more representative measure of the Group's currency risk exposure during the year would be obtained by applying the same principles to the weighted average outstanding loan balance during the year of \$USD 87,500.

⁹ $(\$34,482 \times 1\%) \times (1 - 30\%)$

¹⁰ $(\$87,500 / 1.45) \times 1\% \times (1 - 30\%)$

¹¹ Year end balance = $[(\$50,000 / 1.45) - (\$50,000 / (1.45 \times 0.9))] \times (1 - 30\%)$

Annual interest = $[((\$50,000 \times 6.5\%) / 1.45) - ((\$50,000 \times 6.5\%) / (1.45 \times 0.9))] \times (1 - 30\%)$

¹² Year end balance = $[(\$87,500 / 1.45) - (\$87,500 / (1.45 \times 0.9))] \times (1 - 30\%)$

Annual interest = $[((\$87,500 \times 6.5\%) / 1.45) - ((\$87,500 \times 6.5\%) / (1.45 \times 0.9))] \times (1 - 30\%)$

On this basis the affect of a 10% strengthening of the US Dollar against the Canadian Dollar at the balance sheet date would have resulted in a decrease in post-tax profit for the year of \$CAD 4,999¹². A 10% weakening in the exchange rate would, on the same basis, have increased post-tax profit by \$CAD 4,089.

Disaggregation in disclosures

As the variety and complexity of financial assets and financial liabilities used by an entity increases, so too does the potential complexity of the sensitivity disclosure. As noted above, the standard makes it clear that entities should aggregate the information required by the standard where appropriate; this statement is repeated in this section of the standard, where it is stated that an entity should decide how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments^(Section 3862.B17). The standard provides two examples of conditions that would result in disaggregated information being presented:

- a) an entity that trades financial instruments might disclose sensitivity information separately for financial instruments held for trading and those not held for trading; and
- b) an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

It also requires disaggregated information through:

- the disclosure of a sensitivity analysis for each currency to which an entity has a significant exposure^(Section 3862.B24); and
- the separate disclosure of the sensitivity of equity and the sensitivity of profit or loss^(Section 3862.B27). In the latter case, the standard also suggests that the analysis might show the effect of the changes on interest income and expense and other line items separately^(Section 3862.34).

The standard also indicates that different types of sensitivity analysis may be provided for different classes of financial instrument^(Section 3862.B21). This is particularly the case where there are concentrations of risk within those classes^{(Section 3862.34(c))}.

Where disaggregation is not necessary, such as when an entity has exposure to only one type of market risk in only one economic environment, the standard discourages disaggregation of sensitivity information^(Section 3862.B17).

Other Sensitivity Analysis Disclosures

The standard also requires the disclosure of:

- a) the methods and assumptions used in preparing the sensitivity analysis^{(Section 3862.40(b))}. This should include the timeframe used in determining the reasonably possible changes in the relevant risk, particularly where it is not 12 months (e.g. where the entity has an extended or shortened statutory accounting period); and
- b) changes from the previous period in the methods and assumptions used, and the reasons for such changes^{(Section 3862.40(c))}.

Sensitivity Analysis – Alternative Methods

If the entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the simple analysis. If it chooses to do this, the entity must disclose alongside the analysis^(Section 3862.41).

- a) an explanation of the method used in preparing such a sensitivity analysis, and an explanation of the main parameters and assumptions underlying the data provided; and
- b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

If an entity uses an alternative method of analysing sensitivity for only one category of market risk, it should provide disclosures based on that alternative method for that category and a sensitivity analysis based on the method specified in the standard for the other types of market risk to which it is exposed.

8 Capital Disclosures

Section 1535 was published at the same time as Section 3862. The standard requires an entity to provide disclosures that will enable users of its financial statements to evaluate its objectives, policies and processes for managing capital.

No definition of capital is provided in Section 1535. Instead, like Section 3862, it adopts a management's perspective approach which, as described earlier, requires disclosures to be based on the information provided internally to the entity's Key Management Personnel. The only other guidance within the body of the new Section on what constitutes capital is in paragraph 1535.3(b) which notes that entities may regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (e.g. components of accumulated other comprehensive income arising from cash flow hedges).

Entities may also consider some preference shares as capital, notwithstanding that they are classified as financial liabilities rather than equity. Given the flexibility of what constitutes capital, it would be appropriate for an entity to include an accounting policy in its financial statements, setting out clearly what it regards as constituting capital.

In order to comply with the overall objective of Section 1535, an entity must, as a minimum, disclose:

- a) qualitative information about its objectives, policies and processes for managing capital, including (but not limited to):
 - (i) a description of what it manages as capital;
 - (ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
 - (iii) how it is meeting its objectives for managing capital.
- b) summary quantitative data about what it manages as capital;
- c) any changes in (a) and (b) from the previous period;
- d) whether during the period it complied with any externally imposed capital requirements to which it is subject; and
- e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

Finally, where an entity manages its capital in a number of ways and / or is subject to a number of different capital requirements, aggregate disclosure of capital requirements and how capital is managed may not provide useful information or might distort a financial statement users understanding of the entity's capital resources. In such cases, the entity should disclose separate information for each capital requirement to which it is subject^(Section 1535.04).

The standard includes a simple example of disclosures that might be given by an entity that is not subject to externally imposed capital requirements. In the example, the entity monitors its capital using a debt to adjusted capital ratio. The example is reproduced below.

Facts

Group A manufactures and sells cars. Group A includes a finance subsidiary that provides finance to customers, primarily in the form of leases. Group A is not subject to any externally imposed capital requirements.

Example disclosure

The Group's objectives when managing capital are:

- to safeguard the entity's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to provide an adequate return to shareholders by pricing products and services commensurately with the level of risk.

The Group sets the amount of capital in proportion to risk. The Group manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares, or sell assets to reduce debt.

Consistent with others in the industry, the Group monitors capital on the basis of the debt to adjusted capital ratio. This ratio is calculated as net debt over adjusted capital. Net debt is calculated as total debt (as shown in the balance sheet) less cash and cash equivalents. Adjusted capital comprises all components of equity (i.e. share capital, share premium and retained earnings) other than amounts in accumulated other comprehensive income relating to cash flow hedges, and includes some forms of subordinated debt.

During 2007 the Groups strategy, which was unchanged from 2006, was to maintain the debt-to-adjusted capital ratio at the lower end of the range 6:1 to 7:1, in order to secure access to finance at a reasonable cost by maintaining a BB credit rating. The debt-to-adjusted capital ratios at 31 December 2007 and at 31 December 2006 were as follows:

	2007 \$ million	2006 \$ million
Total debt	1,000	1,100
Less: Cash and cash equivalents	(90)	(150)
Net debt	<u>910</u>	<u>950</u>
Total equity	110	105
Add: Subordinated debt instruments	38	38
Less: amounts in accumulated other comprehensive income relating to cash flow hedges	(10)	(5)
Adjusted capital	<u>138</u>	<u>138</u>
Debt to adjusted capital ratio	6.6	6.9

The decrease in the debt to adjusted capital ratio during 2007 resulted primarily from the reduction in net debt that occurred on the sale of subsidiary Z. As a result of this reduction in net debt, improved profitability and lower levels of managed receivables, the dividend payment was increased to \$2.8 million for 2007 (from \$2.5 million for 2006).

The standard also provides the following example disclosure (Figure 3) for an entity that has not complied with externally imposed capital requirements imposed by a regulator:

Figure 3

Facts

Entity A provides financial services to its customers and is subject to capital requirements imposed by Regulator B. During the year ended 31 December 2007, Entity A did not comply with the capital requirements imposed by Regulator B. In its financial statements for the year ended 31 December 2007, Entity A provides the following disclosure relating to its non-compliance.

Example Disclosure

Entity A filed its quarterly regulatory capital return for 30 September 2007 on 20 October 2007. At that date, Entity A's regulatory capital was below the capital requirement imposed by Regulator B by \$1 million. As a result, Entity A was required to submit a plan to the regulator indicating how it would increase its regulatory capital to the amount required.

Entity A submitted a plan that entailed selling part of its unquoted equities portfolio with a carrying amount of \$11.5 million in the fourth quarter of 2007. In the fourth quarter of 2007, Entity A sold its fixed interest investment portfolio for \$12.6 million and met its regulatory capital requirement.

9 Differential Reporting and Non-Publicly Accountable Enterprises

For enterprises that qualify under Differential Reporting, Section 1300, there is some relief provided from the extensive fair value and impairment disclosures.

Such a qualifying enterprise may elect to disclose the information required by paragraphs 3862.25 - .30A (Fair Value disclosures) only for financial assets and financial liabilities, both recognized and unrecognized, for which fair value is readily obtainable.

An enterprise may also elect to disclose the fair value required by paragraph 3862.37(b1)(i) only for those financial assets for which fair value is readily obtainable.

Fair value is considered to be readily obtainable for financial assets and financial liabilities that have a quoted market price, and for freestanding forward contracts, options and similar derivative instruments. Fair value may also be readily obtainable for other financial assets and liabilities.

In addition to the differential reporting options, an exposure draft that was issued by the Accounting Standards Board for comment in January and has recently been approved, reduces the required disclosures for all non-publicly accountable enterprises. The exposure draft proposes the following changes to Sections 1535 and 3862:

Section 1535 would be amended such that a non-publicly accountable enterprise without externally imposed capital requirements would be exempt from the requirements of the standard and such an entity with externally imposed capital requirements would disclose only:

- the nature of its capital requirements;
- how it manages those requirements; and
- information about compliance with the capital requirements.

Section 3862 would be amended such that non-publicly accountable enterprises need not be required to disclose an analysis of its sensitivity to market risks.

10 Illustrative Example

As noted in Section 2, when considering the illustrative example, it should be borne in mind that the application of the management's perspective approach may result in entities exposed to substantially similar risks providing very different but equally acceptable disclosures, particularly in terms of the structure of the information provided. Entities should ensure that the disclosures made are specific to their own circumstances, the actual risks they face, their own policies and their own management information.

The following example is based on a manufacturing company operating mainly in the automotive and aviation industry supply chains. Its head office function is in Canada and it has manufacturing operations in Canada and the United States. Its customers in the automotive industry are mainly based in Canada and the United States whereas its aviation industry customers are more global.

Note A – Accounting policies¹³

(a) Financial Assets

The Company's financial assets fall into the categories discussed below, with the allocation depending to an extent on the purpose for which the asset was acquired. Although the Company uses derivative financial instruments in economic hedges of currency and interest rate risk, it does not use hedge accounting for these transactions. The Company has not classified any of its financial assets as held to maturity.

Unless otherwise indicated, the carrying amounts of the Company's financial assets are a reasonable approximation of their fair values¹⁴.

(a)(i) Loans and Receivables

These assets are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise principally through the provision of goods and services to customers (e.g. trade receivables), but also incorporate other types of contractual monetary asset. They are initially recognized at fair value plus transaction costs that are directly attributable to the acquisition or issue and subsequently carried at amortized cost using the effective interest rate method, less provision for impairment.

The effect of discounting on these financial instruments is not considered to be material¹⁵.

Impairment provisions are recognized when there is objective evidence (such as significant financial difficulties on the part of the counterparty or default or significant delay in payment¹⁶) that the Company will be unable to collect all of the amounts due under the terms receivable, the amount of such a provision being the difference between the net carrying amount and the estimated realizable amount. For trade receivables, such provisions are recorded in a separate allowance account with the loss being recognized within administrative expenses in the income statement. On confirmation that the trade receivable will not be collectable, the gross carrying value of the asset is written off against the associated provision¹⁷. From time to time, the Company elects to renegotiate the terms of trade receivables due from customers with which it has previously had a good trading history. Such renegotiations will lead to changes in the timing of payments rather than changes to the amounts owed and are not, in the view of the directors, sufficient to require the derecognition of the original instrument¹⁸.

¹³ Sections 3862.21 & B5

¹⁴ Sections 3862.25 & 29(a)

¹⁵ Sections 3862.27(a) & (b)

¹⁶ Section 3862.B5(f)

¹⁷ Section 3862.B5(d)

¹⁸ Section 3862.B5(g)

(a)(ii) Held for Trading

This category comprises only ‘in the money’ interest rate and foreign exchange derivatives (see (b)(i) for ‘out of the money’ derivatives). They are carried in the balance sheet at fair value with changes in fair value recognized in finance income or expense. Other than these derivative financial instruments, the Company does not have any assets that meet the criteria for held for trading nor has it designated any financial assets as held for trading.

The fair value of the Company’s interest rate and foreign exchange derivatives is based on broker quotes for similar instruments¹⁹.

(a)(iii) Available for Sale

Non-derivative financial assets not included in the above categories are classified as available for sale and comprise the Company's investments in corporate bonds²⁰. They are carried at fair value with changes in fair value recognized in other comprehensive income. Where there is a significant or prolonged decline in the fair value²¹ of an available for sale financial asset (which constitutes objective evidence of impairment), the full amount of the impairment, including any amount previously charged to other comprehensive income, is recognized in the income statement. Purchases and sales of available for sale financial assets are recognized on settlement date²² with any change in fair value between trade date and settlement date being recognized in other comprehensive income. On sale, the amount held in accumulated other comprehensive income associated with that asset is removed from accumulated other comprehensive income and recognized in the income statement. Interest on corporate bonds classified as available for sale is calculated using the effective interest method and is recognized in finance income in the income statement²³.

The Company could have elected to designate its investments in corporate bonds as held for trading. However, in its judgement, the board did not consider this the most appropriate treatment as the portfolio does not form part of the Company’s core operations and, in consequence, it was considered that fair value movements (other than impairments) should instead be recorded directly in other comprehensive income²⁴.

The fair value of the Company’s investments in corporate bonds is their quoted market price²⁵.

¹⁹ Sections 3862.27(a) & (b)

²⁰ Section 3862.B5(b)

²¹ Section 3862.B5(f)

²² Section 3862.B5(c)

²³ Section 3862.B5(e)

²⁴ Section 3862.B5

²⁵ Sections 3862.27(a) & (b)

(b) Financial Liabilities

The Company classifies its financial liabilities into one of two categories, depending on the purpose for which the asset was acquired. Although the Company uses derivative financial instruments in economic hedges of currency and interest rate risk, it does not use hedge accounting for these transactions.

Unless otherwise indicated, the carrying amounts of the Company's financial liabilities are a reasonable approximation of their fair values²⁶.

(b)(i) Held for Trading

This category comprises only 'out of-the-money derivatives' (see (a)(ii) for in the money derivatives). They are carried in the balance sheet at fair value with changes in fair value recognized in finance income or expense. Other than these derivative financial instruments, the Company does not have any liabilities that meet the criteria for held for trading nor has it designated any financial liabilities as held for trading.

The methods used for calculating the fair value of the Company's interest rate and foreign exchange derivatives have been described in (a)(ii) above²⁷.

(b)(ii) Financial Liabilities Measured at Amortized Cost

Other financial liabilities include the following items:

- Trade payables and other short-term monetary liabilities, which are initially recognized at fair value and subsequently carried at amortized cost using the effective interest method.
- Bank borrowings and the Company's redeemable preference shares are initially recognized at fair value net of any transaction costs directly attributable to the issue of the instrument. Such interest bearing liabilities are subsequently measured at amortized cost using the effective interest rate method, which ensures that any interest expense over the period to repayment is at a constant rate on the balance of the liability carried in the balance sheet. Interest expense in this context includes initial transaction costs and premium payable on redemption, as well as any interest or coupon payable while the liability is outstanding.

Fair value is calculated discounting estimated future cash flows using a market rate of interest of 6.5% (2006: 6.0%)²⁸.

²⁶ Sections 3862.25 & 29(a)

²⁷ Sections 3862.27(a) & (b)

(c) Share Capital

Financial instruments issued by the Company are treated as equity only to the extent that they do not meet the definition of a financial liability. The Company's redeemable preference shares include a contractual obligation on the company to redeem the shares on demand for cash and deliver cash in the form of the annual preference dividend and, in the absence of any other terms that would indicate an equity element, have been classified wholly as a financial liability. The Company's common shares are classified as equity instruments.

For the purposes of the disclosures given in note H, the Company considers its capital to comprise its common share capital and accumulated retained earnings as well as its redeemable preference shares which are classified as a financial liability in the balance sheet. Accumulated other comprehensive income is considered as capital. There have been no changes in what the Company considers to be capital since the previous period²⁹.

The Company is not subject to any externally imposed capital requirements.

Note B – Finance income and expense^{30, 31}

	2007 \$ '000	2006 \$ '000
Interest income on financial assets classified as loans and receivables	193	125
Interest income on available for sale financial assets	48	37
Total interest income calculated using the effective interest method	<u>241</u>	162
Gains on currency derivatives classified as held for trading	8	2
Gains on interest rate derivatives classified as held for trading	57	33
Gains on available for sale financial assets transferred from equity	11	13
Total finance income	<u>317</u>	210
Interest expense on financial liabilities measured at amortized cost	(1,641)	(1,338)
Net finance costs	<u>(1,324)</u>	<u>(1,128)</u>

In addition to the above, impairment losses on trade receivables of \$89,000 (2006: \$74,000) were recognized in cost of sales.

²⁸ Sections 3862.27(a) & (b)

²⁹ Section 1535.03(c)

³⁰ Section 3862.20

Note C - Categories of Financial Assets and Financial Liabilities³²

	Financial assets classified as held for trading		Loans and receivables		Available for sale financial assets	
	2007	2006	2007	2006	2007	2006
	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000
Current financial assets						
Trade and other receivables	-	-	7,508	3,931	-	-
Cash and cash equivalents	-	-	2,922	3,251	-	-
Derivative financial assets	111	44	-	-	-	-
Investments in corporate bonds	-	-	-	-	774	646
Total current financial assets	111	44	10,430	7,182	774	646

	Financial liabilities classified as held for trading		Financial liabilities measured at amortized cost	
	2007	2006	2007	2006
	\$ '000	\$ '000	\$ '000	\$ '000
Current financial liabilities				
Trade and other payables	-	-	2,281	1,687
Loans and borrowings	-	-	10,467	879
Derivative financial liabilities	2	1	-	-
Total current financial liabilities	2	1	13,748	2,566
Non-current financial liabilities				
Loans and borrowings	-	-	10,000	15,000
Total non-current financial liabilities	-	-	10,000	15,000
Total financial liabilities	2	1	23,748	17,566

The Company has pledged corporate bonds with a balance sheet date carrying value of \$495,000 (2006: \$450,000) as collateral against certain bank loans. The assets are held in escrow and the counterparty has no right to sell or re-pledge the assets; they will only pass to the counterparty in the event the Company defaults on its obligations under the relevant loan agreements. In the event of a decrease in value of the collateral held below \$450,000, the Company is obliged to pledge further corporate bonds in order to maintain that value. To the extent that the value of bonds pledged exceeds \$500,000, the Company is entitled to remove the excess from escrow³³.

³¹ Note the statement of comprehensive income, not reproduced in this example, should include a separate line item for the unrealized gains or losses recognized on the Company's corporate bonds.

³² Section 3862.8

³³ Section 3862.14

Note D – Trade and Other Receivables³⁴

	2007	2006
	\$ '000	\$ '000
Trade receivables	<u>7,508</u>	3,931
Total loans and receivables	7,508	3,931
Prepayments	<u>264</u>	253
	<u><u>7,772</u></u>	<u>4,184</u>

The Company records impairment losses on its trade receivables separately from gross receivable. The movements on this allowance account during the year are summarised below:

	2007	2006
	\$ '000	\$ '000
Opening balance	275	226
Increases in allowance	89	74
Written off against allowance	(35)	(21)
Recovered amounts reversed	<u>121</u>	(4)
Closing balance	<u><u>450</u></u>	<u>275</u>

Note E – Derivative Financial Instruments

	2007	2006
	\$ '000	\$ '000
Current assets		
Forward exchange contracts	21	12
Interest rate swaps	<u>90</u>	33
Total 'in the money' derivatives	111	44
Current liabilities		
Forward exchange contracts	<u>(2)</u>	(1)
Total 'out of the money' derivatives	(2)	(1)
Net derivative financial instruments	<u><u>108</u></u>	<u>43</u>

The Company has used interest rate swaps to fix interest payments at 6.0 per cent on the \$5 million loan repayable in 2017 and 5.5 per cent in respect of the \$5 million loan repayable in 2015, interest receivable on these swaps is LIBOR. Both interest rate swaps expire in December 2010.

³⁴ Section 3862.16

The Company also uses forward exchange contracts to mitigate the effect of fluctuations in the US Dollar / Canadian Dollar exchange rate. At the balance sheet date, the Company had forward exchange contracts over \$376,000 (2006: \$224,000) of purchases, all of which mature within two months.

Note F – Loans and Borrowings

	2007 \$ '000	2006 \$ '000
Current loans and borrowings		
Accrued preference dividend	1,000	-
Preference shares	10,000	10,000
Bank overdraft	<u>467</u>	<u>879</u>
Total current loans and borrowings	11,467	10,879
Non-current loans and borrowings		
Bank loans	<u>10,000</u>	<u>5,000</u>
Total loans and borrowings	<u>21,467</u>	<u>15,879</u>

Due to an administrative error, the Company failed to pay the dividend due on its preference shares on 31 December 2007; payment in full was subsequently made on 2 January 2008³⁵.

The fair value of the Company's Cumulative Perpetual 10% Preference shares (excluding the accrued preference dividend) at the balance sheet date was \$10.5 million (2006: \$11 million)³⁶. For the Company's other loans and borrowings, the carrying amounts are a reasonable approximation of the financial instruments' fair value³⁷.

The Company has two bank loans of \$5 million repayable, in a single payment, in 2015 and 2017 respectively. Monthly interest is payable on these loans at LIBOR +0.5%³⁸, although, as stated in note E, the Company uses interest rate swaps to mitigate interest rate risk.

Prior to the increase in borrowing in the year, the Company renegotiated its net debt to equity ratio-related covenant on its existing \$5 million loan. Both loans require the Company to maintain net debt to equity ratio of less than 35% (2006: 15%).

³⁵ Section 3862.18

³⁶ Section 3862.25

³⁷ Section 3862.29(a)

Note G – Financial Instrument Risk Exposure and Management

In common with all other businesses, the Company is exposed to risks that arise from its use of financial instruments. This note describes the Company's objectives, policies and processes for managing those risks and the methods used to measure them. Further quantitative information in respect of these risks is presented throughout these financial statements.

There have been no substantive changes in the Company's exposure to financial instrument risks, its objectives, policies and processes for managing those risks or the methods used to measure them from previous periods unless otherwise stated in this note³⁹.

Principal Financial Instruments

The principal financial instruments used by the Company, from which financial instrument risk arises, are as follows⁴⁰:

- trade receivables;
- cash at bank;
- bank overdrafts;
- restricted cash collateral held;
- investments in corporate bonds;
- trade and other payables;
- floating-rate bank loans (Repayable on their 10th anniversary);
- redeemable preference shares with a cumulative annual 10% dividend;
- interest rate swaps; and
- forward currency contracts.

³⁸ Section 3862.07

³⁹ Section 3862.33(c)

⁴⁰ Section 3862.33(a)

General Objectives, Policies and Processes

The Board has overall responsibility for the determination of the Company's risk management objectives and policies and, while retaining ultimate responsibility for them, it has delegated the authority for designing and operating processes that ensure the effective implementation of the objectives and policies to the Company's finance function. The Board receives monthly reports from the Company Financial Controller through which it reviews the effectiveness of the processes put in place and the appropriateness of the objectives and policies it sets. The Company's internal auditors also review the risk management policies and processes and report their findings to the Audit Committee⁴¹.

The overall objective of the Board is to set policies that seek to reduce risk as far as possible without unduly affecting the Company's competitiveness and flexibility. Further details regarding these policies are set out below.

Credit Risk

Credit risk arises principally from the Company's trade receivables and investments in corporate bonds. It is the risk that the counterparty fails to discharge its obligation in respect of the instrument.

Trade Receivables

Prior to accepting new customers, a credit check is obtained from a reputable external source (XYZ Credit Company Ltd). Based on this information, credit limits and payment terms are established and authorized by the Chief Financial Officer or the Board depending on the size of account requested. Credit limits may only be exceeded with the authorisation of the Chief Financial Officer or the Board depending on the extent to which the terms are expected to be exceeded and the Company's trading history with that customer. Customers who subsequently fail to meet their credit terms are required to make purchases on a prepayment basis until creditworthiness can be re-established. The nature of the Company's operations means that approximately 60% (2006: 66%) of its sales are made to six (2006: five) key customers operating in the North American automotive industry and, while credit risk is mainly influenced by factors specific to these individual customers, the concentration of sales both geographically and by industry is a contributory factor. The reduction in risk concentration is due principally to the Company's expansion of its operations supplying the aviation industry. The Board is continuing to seek other opportunities to diversify the Company's operations both geographically and the sectors they supply.

⁴¹ Sections 3862.33(b) & IG15(b)(i)

The Board receives monthly reports summarising the sales, trade receivable balance and aging profile of each of the key customers individually and the Company's other customers analyzed by industry sectors as well as a list of customers currently transacting on a prepayment basis or who have balances in excess of their credit limits.

The table below illustrates the concentrations of credit risk within the Company as at the balance sheet date⁴²:

Sales and Trade Receivable Aging by Business Segment

2007	Sales	Trade receivables			
		Total	Current	30-days past due	+60-days past due
		\$ '000	\$ '000	\$ '000	\$ '000
Key customers - Automotive	37,540	2,252	1,509	586	158
Other customers - Automotive	9,385	1,952	878	878	195
Total - Automotive	46,925	4,205	2,388	1,464	353
Key customers - Aviation	6,257	1,652	975	496	182
Other customers - Aviation	4,380	1,051	610	294	147
Total - Aviation	10,636	2,703	1,584	790	329
Other	5,005	601	408	144	48
Total	62,567	7,508	4,380	2,398	730

2006	Sales	Trade receivables			
		Total	Current	30-days past due	+60-days past due
		\$ '000	\$ '000	\$ '000	\$ '000
Key customers - Automotive	28,827	1,651	1,090	479	83
Other customers - Automotive	7,425	668	408	214	47
Total - Automotive	36,252	2,319	1,497	693	129
Key customers - Aviation	0	983	580	334	69
Other customers - Aviation	3,494	354	230	92	32
Total - Aviation	3,494	1,337	810	426	101
Other	3,931	275	176	83	17
Total	43,677	3,931	2,483	1,201	246

Sales and Trade Receivable Aging by Geographical Segment

2007	Sales	Trade receivables			
		Total	Current	30-days past due	+60-days past due
		\$ '000	\$ '000	\$ '000	\$ '000
North America	43,797	5,256	3,066	1,679	511
Europe	12,513	1,502	876	480	146
Rest of world	6,257	751	438	240	73
Total	62,567	7,508	4,380	2,398	730

2006	Sales	Trade receivables			
		Total	Current	30-days past due	+60-days past due
		\$ '000	\$ '000	\$ '000	\$ '000
North America	26,206	2,359	1,490	721	148
Europe	10,919	983	621	300	62
Rest of world	6,552	590	372	180	37
Total	43,677	3,931	2,483	1,201	246

Included within current other-automotive / North American trade receivables are balances totalling \$99,750, the terms of which were renegotiated in the year. If the terms had not been renegotiated, these balances would have been included in the +60-days category⁴³.

⁴³ Section 3862.36(d)

The Company requires certain customers operating in the aviation industry to maintain a cash collateral balance in a restricted bank account in the name of the Company. These funds can be drawn on by the Company only in the event of a default by the customer; they can be released to the customer only by agreement of both parties⁴⁴. During the year the Company took full possession of \$10,000 cash that was held as collateral against the trade receivables of a customer that ceased to trade⁴⁵.

Investments in Corporate Bonds

The Company maintains a low exposure to credit risk in respect of its investments in corporate bonds by investing only in Standard & Poor BBB⁴⁶ or higher graded Canadian⁴⁷ corporate bonds. The Board must give its approval prior to investment decisions being taken and receives a report detailing the value of corporate bonds held analyzed by their credit rating on a monthly basis⁴⁸. In the event that the credit rating of a corporate bond held is downgraded to below BBB, the Company will seek to dispose of the investment as soon as is practicable.

⁴⁴ Sections 3862.36(b), IG22 & 15

⁴⁵ Section 3862.38

⁴⁶ Section 3862.IG24(b)

⁴⁷ Section 3862.34(c)

⁴⁸ Sections 3862.33(b) & IG15(b)(ii)

Maximum Exposure to Credit Risk

The Company's maximum exposure to credit risk, by class of financial instrument is shown in the table below⁴⁹:

Maximum Credit Risk Exposure

	2007		2006	
	Carrying value	Maximum exposure	Carrying value	Maximum exposure
	\$ '000	\$ '000	\$ '000	\$ '000
Trade receivables				
Key customers - Automotive	2,252	2,252	1,651	1,651
Other customers - Automotive	1,952	1,952	668	668
Key customers - Aviation	1,652	1,652	983	983
Other customers - Aviation	1,051	1,051	354	354
Other	601	601	275	275
Total trade receivables	7,508	7,508	3,931	3,931
Cash and cash equivalents	2,922	2,922	3,251	3,251
Derivative financial assets				
Currency forwards	21	21	12	12
Interest rate swaps	90	90	33	33
Total derivative financial assets	111	111	44	44
Investments in corporate bonds				
AAA-rated	469	469	352	352
A-AA-rated	251	251	294	294
BBB-rated	54	54	0	0
Total investments	774	774	646	646
Maximum credit risk exposure	<u>11,315</u>	<u>11,315</u>	<u>7,872</u>	<u>7,872</u>

The maximum credit risk for trade receivables analyzed by geographical concentration can be seen in the 'sales and aged trade receivable by geographical segment' table in the trade receivables section above; there is no difference between the carrying amount and the maximum credit risk exposure⁵⁰.

⁴⁹ Section 3862.36(a)

⁵⁰ Sections 3862.34(c) & B8(c)

*Credit Quality – Financial Assets Neither Past Due Nor Impaired*⁵¹

An analysis of the Company's current, net trade receivable balance by credit rating along with historical default rates is shown in the table below:

XYZ Credit Company Ltd Credit Rating

	2007	2006	Historic default rate*
	\$ '000	\$ '000	
Current net trade receivables			
A	2,453	1,490	1%
B	1,139	521	2%
C	307	174	5%
D	219	124	7%
Unrated	263	174	4%
Total current trade receivables	<u>4,380</u>	<u>2,483</u>	

* Historical percentage of defaults on gross carrying value.

An analysis by the nature of counterparty (industry and geographical segment) can be seen in the 'sales and aged trade receivable' tables in the trade receivables section above.

Financial Assets Past Due or Impaired

The analysis of the Company's provisions against trade receivables is shown in the table below:

⁵¹ Sections 3862.36(c), IG23(a), IG23(c), IG24(a), IG24(c)

Analysis of Trade Receivable Impairments

	2007			2006		
	Gross value	Allowance	Net carrying amount	Gross value	Allowance	Net carrying amount
	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000
Key customers - Automotive	2,388	(135)	2,252	1,767	(116)	1,651
Other customers - Automotive	2,069	(117)	1,952	715	(47)	668
Key customers - Aviation	1,751	(99)	1,652	1,052	(69)	983
Other customers - Aviation	1,114	(63)	1,051	379	(25)	354
Other	637	(36)	601	294	(19)	275
	<u>7,959</u>	<u>(450)</u>	<u>7,508</u>	<u>4,206</u>	<u>(275)</u>	<u>3,931</u>
North America	5,571	(315)	5,256	2,524	(165)	2,359
Europe	1,592	(90)	1,502	1,052	(69)	983
Rest of world	796	(45)	751	631	(41)	590
	<u>7,959</u>	<u>(450)</u>	<u>7,508</u>	<u>4,206</u>	<u>(275)</u>	<u>3,931</u>

An analysis of the age of financial assets that are past due as at the reporting date but are not impaired can be seen in the 'trade receivables' section above⁵². The main factor used in assessing the impairment of trade receivables is the age of the balance and the circumstances of the individual customer⁵³. The fair value of trade receivables that are past due or impaired is their carrying amount⁵⁴.

An analysis of the Company's investments in corporate bonds by credit rating is shown in the 'Maximum credit risk exposure' section above. None of that balance is past due or impaired⁵⁵.

Liquidity Risk

Liquidity risk arises from the Company's management of working capital and the finance charges and principal repayments on its debt instruments. It is the risk that the Company will encounter difficulty in meeting its financial obligations as they fall due⁵⁶.

⁵² Section 3862.37(a)

⁵³ Section 3862.37(b)

⁵⁴ Section 3862.37(c)

⁵⁵ Section 3862.37(a)

⁵⁶ Section 3862.33(a)

The Company's policy is to ensure that it will always have sufficient cash to allow it to meet its liabilities when they become due. To achieve this aim, it seeks to maintain cash balances (or agreed facilities) to meet expected requirements for a period of at least 45 days. The Company also seeks to reduce liquidity risk by fixing interest rates (and hence cash flows) on its long-term borrowings⁵⁷, this is further discussed in the 'interest rate risk' section below.

The Board receives rolling 12-month cash flow projections on a monthly basis as well as information regarding cash balances and (as noted above) the value of the Company's investments in corporate bonds⁵⁸. At the balance sheet date, these projections indicated that the Company expected to have sufficient liquid resources to meet its obligations under all reasonably expected circumstances and will not need to draw down on its agreed \$1 million overdraft facility.

The following table illustrates the contractual maturity analysis of the Company's financial liabilities and derivative financial assets and liabilities that must be settled gross⁵⁹ based, where relevant, on balance sheet interest rates and exchange rates prevailing at the balance sheet date.

2007	Gross undiscounted cash flows due							
	on demand	in 1 month	between 1 and 6 months	between 6 months and 1 year	between 1 and 3 years	between 3 and 5 years	between 5 and 10 years	Total
	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000
Non-derivative financial instruments	(1,676)	(2,126)	(271)	(1,325)	(1,650)	(4,950)	(17,302)	(29,300)
Derivative financial instruments								
Cash out flows	-	(3)	(2)	(3)	(8)	-	-	(16)
Cash in flows	-	8	23	26	55	-	-	111
	<u>(1,676)</u>	<u>(2,122)</u>	<u>(250)</u>	<u>(1,302)</u>	<u>(1,604)</u>	<u>(4,950)</u>	<u>(17,302)</u>	<u>(29,205)</u>
2006	Gross undiscounted cash flows due							
	on demand	in 1 month	between 1 and 6 months	between 6 months and 1 year	between 1 and 3 years	between 3 and 5 years	between 5 and 10 years	Total
	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000	\$ '000
Non-derivative financial instruments	(997)	(1,594)	(125)	(1,150)	(1,300)	(3,900)	(11,200)	(20,266)
Derivative financial instruments								
Cash out flows	-	(2)	(1)	(2)	(4)	-	-	(8)
Cash in flows	-	3	7	8	16	-	-	33
	<u>(997)</u>	<u>(1,593)</u>	<u>(119)</u>	<u>(1,144)</u>	<u>(1,288)</u>	<u>(3,900)</u>	<u>(11,200)</u>	<u>(20,241)</u>

⁵⁷ Sections 3862.33(b), 39(b), IG15(b)(iii) & IG31

⁵⁸ Sections 3862.IG15(b)(ii) & IG15(b)(iv)

⁵⁹ Sections 3862.39(a) & B11-B16

The dividend payable on the Company's 10% redeemable preference shares has been included in the analysis shown. Although the preference shares are redeemable on demand, they have been excluded from this analysis as the Company does not anticipate them being redeemed due to the fact that the preference shares are publicly traded and the dividend rate is well in excess of current and expected interest rates⁶⁰.

The gross undiscounted annual finance charge of \$1 million has not been analyzed beyond the final contractual maturity date of the Company's debt with finite repayment terms (December 2015).

Market Risk

Market risk arises from the Company's use of interest bearing, tradable and foreign currency financial instruments. It is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in interest rates (interest rate risk), foreign exchange rates (currency risk) or other market factors (other price risk).

Interest Rate Risk

It is the Company's policy either to eliminate interest rate risk over the cash flows on its long-term debt finance through the use of fixed rate instruments (such as its 10% cumulative preference shares) or to mitigate the risk through the use of floating-to fixed-interest rate swaps⁶¹. The Company currently has a floating- to fixed-rate swap over 100% of its floating-rate borrowings that expire in December 2010⁶². While this is an economic hedge of the cash flow risk, the Company does not apply hedge accounting.

The Company invests surplus cash in publicly traded corporate bonds and in doing so it exposes itself to the fluctuations in interest rates that are inherent in such a market. The Board makes investment decisions after considering advice received from professional advisors. The annualised effect of a 0.5% decrease in the interest rate at the balance sheet date on the variable rate debt carried at that date would, all other variables held constant, have resulted in an increase in post-tax profit for the year of \$70,000 (2006: \$35,000). A 0.5% increase in the interest rate would, on the same basis, have decreased post-tax profit by the same amount⁶³.

⁶⁰ Section 3862.IG30

⁶¹ Section 3862.IG16

⁶² Sections 3862.33(a), 33(b) & IG15(b)(iii)

⁶³ Section 3862.40

The effect of fluctuations in interest rates on the variable rate debt is partially off set through the use of interest rate swaps. The annualised affect of a 0.5% decrease in the interest rate at the balance sheet date on the interest rate swaps carried at that date would, all other variables held constant, have resulted in a decrease in post-tax profit for the year of \$83,000 (2006: \$46,000). A 0.5% increase in the interest rate would on the same basis have increased post-tax profit by the same amount⁶⁴.

Currency Risk

The Company is exposed to currency risk on purchases made from a major supplier based in the USA. Purchases from this supplier are made on a central basis and the risk is hedged using forward exchange contracts. Whilst this is an economic hedge of the cash flow risk, the Company does not apply hedge accounting⁶⁵. At the balance sheet date the Company had trade payables of \$209,000 (2006: \$118,000) denominated in US Dollars.

The affect of a \$0.25 strengthening of the US Dollar against the Canadian Dollar at the balance sheet date on the US Dollar denominated trade payables carried at that date would, all other variables held constant, have resulted in a decrease in post-tax profit for the year of \$24,000 (2006: \$13,000). A \$0.25 weakening in the exchange rate would, on the same basis, have increased post-tax profit by \$18,000 (2006: \$10,000)⁶⁶.

The affect of fluctuations in exchange rates on the US Dollar denominated trade payables is partially off set through the use of forward exchange contracts. The affect of a \$0.25 strengthening of the US Dollar against the Canadian Dollar at the balance sheet date on the forward currency swaps carried at that date would, all other variables held constant, have resulted in an increase in post-tax profit for the year of \$20,000 (2006: \$12,000). A \$0.25 weakening in the exchange rate would, on the same basis, have decreased post-tax profit by \$19,000 (2006: \$10,000)⁶⁷.

⁶⁴ Section 3862.40

⁶⁵ Sections 3862.33(a), 33(b) & IG15(b)(iii)

⁶⁶ Section 3862.40

⁶⁷ Section 3862.40

Other Price Risk

The Company invests surplus cash in publicly traded corporate bonds and in doing so it exposes itself to the fluctuations in price that are inherent in such a market. The Board makes investment decisions on advice from professional advisors.

The effect of a 10% increase in the value of the corporate bonds held at the balance sheet date would, all other variables held constant, have resulted in an increase in other comprehensive income of \$77,000 (2006: \$65,000). A 10% decrease in their value would, on the same basis, have decreased other comprehensive income by the same amount⁶⁸.

Note H – Capital

As described in note A(c) the Company considers its capital to comprise its ordinary share capital and accumulated retained earnings as well as its redeemable preference shares which are classified as a financial liability in the balance sheet⁶⁹.

In managing its capital, the Company's primary objective is to ensure its continued ability to provide a consistent return for its equity shareholders through a combination of capital growth and distributions and through the payment of annual preference dividends to its preference shareholders. In order to achieve this objective, the Company seeks to maintain a net debt to equity ratio that balances risks and returns at an acceptable level and also to maintain a sufficient funding base to enable the Company to meet its working capital and strategic investment needs. In making decisions to adjust its capital structure to achieve these aims, either through altering its dividend policy, new share issues, or the reduction of debt, the Company considers not only its short-term position but also its long-term operational and strategic objectives⁷⁰.

It is the Company's policy to maintain its net debt to equity ratio within the range of 25-35% (2006: 5-15%). The Company's net debt to equity ratio at the balance sheet date is shown below⁷¹:

⁶⁸ Section 3862.40

⁶⁹ Section 1535.3(a)

⁷⁰ Section 1535.3

⁷¹ Section 1535.3



	2007	2006
	\$ '000	\$ '000
Cash and cash equivalents	(2,922)	(3,251)
Corporate bonds	(774)	(646)
Bank overdrafts	467	879
Bank loans	<u>10,000</u>	<u>5,000</u>
Net debt	<u><u>6,771</u></u>	<u><u>1,982</u></u>
	2007	2006
	\$ '000	\$ '000
Share capital	3,000	3,000
Retained profit	8,692	7,259
Redeemable Preference shares	<u>10,000</u>	<u>10,000</u>
Total capital	<u><u>21,692</u></u>	<u><u>20,259</u></u>
Net debt to equity ratio	31%	10%

The increase in net debt to equity ratio has been bought about by the Board's decision to take on additional debt finance to fund the acquisition of a new subsidiary; the Company intends to maintain this net debt to equity levels going forward. There have been no other significant changes to the Company's capital management objectives, policies and processes in the year nor has there been any change in what the Company considers to be its capital⁷².

⁷² Section 1535.3

