FINANCIAL INSTRUMENTS: DISCLOSURES (IFRS 7)

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<u>Important</u>: We strongly suggest that you study the chapter on IFRS 9: Financial Instruments *before tackling this chapter.*

1. Purpose and Scope of IFRS 7

IFRS 7 requires entities to disclose information that enables users of financial statements to evaluate:

1. **The significance of financial instruments** for the entity's financial position and performance.
2. **The nature and extent of risks** arising from financial instruments, and how the entity manages those risks.

IFRS 7 applies to **all financial instruments**, except:

- Interests in subsidiaries, associates, joint ventures accounted for under IFRS 10/IAS 28
- Insurance contracts (IFRS 17)
- Share-based payments (IFRS 2)
- Certain contracts under IFRS 15

2. Key Definitions (Exam-Critical)

- **Financial Instrument:** Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another.
- **Financial Asset:** Cash, equity instruments of another entity, contractual rights to receive cash, etc.
- **Financial Liability:** Contractual obligation to deliver cash or another financial asset.
- **Equity Instrument:** Contract evidencing residual interest in assets after deducting liabilities.

3. Categories of Disclosures Required by IFRS 7

A. Significance of Financial Instruments

These disclosures explain how financial instruments affect:

- Financial position (statement of financial position)
- Financial performance (profit or loss)
- Cash flows

B. Nature and Extent of Risks

These disclosures explain:

- What risks the entity is exposed to
- How those risks arise
- How the entity manages them
- Quantitative exposure to those risks

SECTION A: SIGNIFICANCE OF FINANCIAL INSTRUMENTS

4. Statement of Financial Position Disclosures

4.1 Carrying Amounts by Category

Entities must disclose carrying amounts of financial instruments by IFRS 9 classification:

- **Financial assets at amortised cost**
- **Financial assets at FVOCI (debt)**
- **Financial assets at FVOCI (equity)**
- **Financial assets at FVTPL**
- **Financial liabilities at amortised cost**
- **Financial liabilities at FVTPL**

Example:

ABC Ltd has the following financial instruments:

- Trade receivables: R 1 200 000 (amortised cost)
- Investments in government bonds: R 3 000 000 (FVOCI)
- Listed equity shares: R 800 000 (FVTPL)
- Bank loan: R 5 000 000 (amortised cost)

Disclosure extract:

➔ Financial assets at amortised cost: R 1 200 000
➔ Financial assets at FVOCI: R 3 000 000
➔ Financial assets at FVTPL: R 800 000
➔ Financial liabilities at amortised cost: R 5 000 000

5. Statement of Profit or Loss Disclosures

Entities must disclose:

- Net gains/losses by category
- Interest revenue and interest expense
- Fee income and fee expense
- Impairment losses (ECL)
- Gains/losses from derecognition
- Gains/losses from modifications

Example:

- Interest income on trade receivables: R 45 000
- Impairment loss (ECL): R 120 000
- Fair value gain on equity shares (FVTPL): R 60 000

Disclosure extract:

➔ Interest income (amortised cost): R 45 000
➔ Impairment losses (ECL): R 120 000
➔ Net fair value gain (FVTPL): R 60 000

6. Other Significant Disclosures

6.1 Accounting Policies

Clear description of:

- Classification
- Measurement
- ECL methodology
- Write-off policy

6.2 Fair Value Disclosures

Required when:

- Financial instruments are measured at fair value
- Fair value is disclosed for amortised cost instruments

It must include:

- Fair value hierarchy (Level 1, 2, 3)
- Valuation techniques
- Inputs used

Examples:

- Equity shares (Level 1): Quoted market prices
- Government bonds (Level 2): Discounted cash flow
- Unlisted shares (Level 3): Net asset value method

SECTION B: NATURE AND EXTENT OF RISKS

IFRS 7 requires disclosures for **three main risk categories**:

1. **Credit risk**
2. **Liquidity risk**
3. **Market risk**
    - Interest rate risk
    - Currency risk
    - Other price risk

7. Credit Risk Disclosures

7.1 Definition

Risk that a counterparty will default, causing financial loss.

7.2 Required Disclosures

- Maximum exposure to credit risk
- Collateral held
- Credit quality information
- ECL methodology
- Ageing analysis
- Write-offs and recoveries

Example:

<u>**Trade receivables ageing**</u>**:**

Age	Amount	ECL %	ECL (R)
Current	R 900 000	2%	R 18 000
30 days	R 200 000	5%	R 10 000
60 days	R 100 000	20%	R 20 000

➔ **Total ECL:** R 48 000

8. Liquidity Risk Disclosures

8.1 Definition

Risk that the entity cannot meet its obligations when due.

8.2 Required Disclosures

- Maturity analysis of financial liabilities
- How liquidity risk is managed
- Undrawn facilities

Example:

Bank loan repayment schedule:

Period	Cash Outflow
< 1 year	R 1 000 000
1–2 years	R 1 500 000
2–5 years	R 2 500 000

9. Market Risk Disclosures

9.1 Sensitivity Analysis

Entities must disclose how profit/equity would change with:

- 1% interest rate change
- 10% currency change
- 10% equity price change

Example:

Equity shares at FVTPL: R 800 000

- ➔ 10% increase → gain R 80 000
- ➔ 10% decrease → loss R 80 000

10. Offsetting Disclosures (IAS 32 Link)

Required when:

- Financial assets and liabilities are offset
- There are enforceable netting arrangements

Must disclose:

- Gross amounts
- Amounts offset
- Net amounts

11. Hedge Accounting Disclosures (IFRS 9 Link)

If hedge accounting is applied, disclose:

- Risk management strategy
- Hedged items and hedging instruments
- Hedge effectiveness
- Gains/losses recognised

Example:

ABC Ltd hedges USD purchases using forward contracts.

- Fair value gain on forward: R 50 000
- Hedged item adjustment: R 50 000

12. Practical Examples (South African Context)

Example 1: Bank Loan Disclosure

ABC Ltd has:

- R 5 000 000 loan
- Floating interest rate (prime + 1%)
- Maturity: 5 years

Disclosures:

- Interest rate risk sensitivity
- Liquidity risk maturity table
- Fair value (Level 2)
- Covenant compliance

Example 2: Trade Receivables Portfolio

ABC Ltd sells to 300 customers.

Disclosures include:

- Credit risk concentration
- ECL model
- Ageing
- Collateral (if any)

13. Exam-Style Summary

You MUST be able to:

- Identify all IFRS 7 disclosure categories
- Prepare risk disclosures (credit, liquidity, market)
- Prepare fair value hierarchy notes
- Prepare sensitivity analyses
- Explain ECL methodology
- Link IFRS 7 with IFRS 9 and IAS 32

14. Exam Questions (With Answers)

Question 1

Explain the purpose of IFRS 7 and list its two main disclosure categories.

Answer: Purpose: To enable users to evaluate the significance of financial instruments and the nature/extent of risks. Categories:

1. Significance of financial instruments
2. Nature and extent of risks

Question 2

Provide an example of a liquidity risk maturity analysis.

Answer:

- ➔ <1 year: R 1 000 000
- ➔ 1–2 years: R 1 500 000
- ➔ 2–5 years: R 2 500 000

Question 3

ABC Ltd holds equity shares at FVTPL of R 600 000. Provide the required market risk sensitivity disclosure.

Answer:

- ➔ 10% increase → gain R 60 000
- ➔ 10% decrease → loss R 60 000

Question 4

List three credit risk disclosures required by IFRS 7.

Answer:

- Maximum exposure
- Ageing analysis
- ECL methodology

15. FULL EXAM QUESTION PACK (WITH MEMO)

SECTION A — MULTIPLE-CHOICE QUESTIONS (20 marks)

(Each question = 1 mark)

MCQ 1

The primary purpose of IFRS 7 is to require entities to disclose information that enables users to evaluate:

A. The fair value of all financial instruments
B. The significance of financial instruments and the nature/extent of risks
C. The accounting policies of the entity
D. The effectiveness of internal controls

Answer: B

MCQ 2

Which of the following is *not* a risk category under IFRS 7?

A. Credit risk
B. Liquidity risk
C. Market risk
D. Operational risk

Answer: D

MCQ 3

A Level 1 fair value measurement is based on:

A. Unobservable inputs
B. Quoted prices in active markets
C. Discounted cash flow models
D. Broker quotes

Answer: B

MCQ 4

Which of the following financial instruments is *outside* the scope of IFRS 7?

A. Trade receivables
B. Bank loans
C. Insurance contracts
D. Equity investments

Answer: C

MCQ 5

Liquidity risk refers to:

A. The risk of loss due to changes in market prices
B. The risk that a counterparty will default
C. The risk that an entity cannot meet obligations when due
D. The risk of changes in interest rates

Answer: C

MCQ 6

Which disclosure is required for credit risk?

A. Maturity analysis
B. Sensitivity analysis
C. Maximum exposure to credit risk
D. Hedge effectiveness

Answer: C

MCQ 7

Market risk includes all of the following except:

A. Currency risk
B. Interest rate risk
C. Other price risk
D. Default risk

Answer: D

MCQ 8

A 10% increase in the fair value of equity instruments measured at FVTPL must be disclosed as part of:

A. Liquidity risk
B. Market risk sensitivity
C. Credit risk
D. Hedge accounting

Answer: B

MCQ 9

Which of the following is a Level 3 input?

A. Quoted share prices
B. Observable yield curves
C. Net asset value of an unlisted entity
D. Market interest rates

Answer: C

MCQ 10

Offsetting disclosures are required when:

A. The entity has derivatives
B. The entity has enforceable netting arrangements
C. The entity has trade receivables
D. The entity has bank loans

Answer: B

MCQ 11

Which of the following must be disclosed for financial instruments measured at amortised cost?

A. Fair value
B. Hedge effectiveness
C. Credit rating
D. Collateral pledged

Answer: A

MCQ 12

Sensitivity analysis for interest rate risk typically uses:

A. 1% change
B. 5% change
C. 10% change
D. 20% change

Answer: A

MCQ 13

Which of the following is *not* required for ECL disclosures?

A. Ageing analysis
B. Write-off policy
C. Collateral held
D. Dividend policy

Answer: D

MCQ 14

Fair value hierarchy disclosures are required for:

A. All financial instruments
B. Only those measured at fair value
C. Only those measured at amortised cost
D. Only derivatives

Answer: B

MCQ 15

Which of the following is a market risk?

A. Customer default
B. Exchange rate fluctuations
C. Late payments
D. Covenant breaches

Answer: B

MCQ 16

IFRS 7 requires disclosure of:

A. ECL model assumptions
B. Tax reconciliation
C. PPE useful lives
D. Inventory costing method

Answer: A

MCQ 17

Liquidity risk disclosures include:

A. Sensitivity analysis
B. Maturity analysis
C. Credit ratings
D. Hedge ratios

Answer: B

MCQ 18

Which of the following is an example of collateral?

A. Trade receivables
B. Bank guarantees
C. Deferred tax assets
D. Inventory

Answer: B

MCQ 19

A financial asset is offset against a financial liability when:

A. The entity chooses to
B. There is a legal right to offset
C. The items are similar
D. The entity is under liquidity pressure

Answer: B

MCQ 20

Which of the following must be disclosed for hedge accounting?

A. Risk management strategy
B. PPE valuation
C. Inventory turnover
D. Tax losses

Answer: A

SECTION B — SHORT QUESTIONS (20 marks)

(Each question = 4 marks)

Question 1

List and briefly explain the three types of market risk under IFRS 7.

Answer:

- **Interest rate risk:** Risk of changes in interest rates affecting financial instruments.
- **Currency risk:** Risk of changes in foreign exchange rates.
- **Other price risk:** Risk of changes in market prices (e.g., equity prices).

Question 2

Explain what a Level 3 fair value measurement is and give one example.

Answer: Level 3 uses **unobservable inputs**. Example: Valuation of unlisted shares using net asset value.

Question 3

Provide two examples of credit risk disclosures.

Answer:

- Maximum exposure to credit risk
- Ageing analysis of receivables

Question 4

Explain the purpose of a liquidity risk maturity analysis.

Answer: Shows when financial liabilities fall due, helping users assess whether the entity can meet obligations.

Question 5

Explain why sensitivity analysis is required for market risk.

Answer: It shows how profit/equity would change under reasonably possible changes in market variables.

SECTION C — LONG-FORM QUESTIONS (60 marks)

QUESTION 1 — CREDIT RISK & ECL (25 marks)

Scenario:

ABC Ltd has trade receivables of R 1 500 000. The ageing analysis and ECL rates are:

Age	Amount	ECL %
Current	R 900 000	2%
30 days	R 300 000	5%
60 days	R 200 000	20%
90+ days	R 100 000	50%

Required:

1. Calculate the total ECL (10 marks)
2. Prepare the required IFRS 7 credit risk disclosures (15 marks)

Solution:

1. ECL Calculation

- Current: 900 000 × 2% = **R 18 000**
- 30 days: 300 000 × 5% = **R 15 000**
- 60 days: 200 000 × 20% = **R 40 000**
- 90+ days: 100 000 × 50% = **R 50 000**

➔ **Total ECL = R 123 000**

2. IFRS 7 Disclosures

- Maximum exposure: R 1 500 000
- Collateral: None
- ECL methodology: Provision matrix
- Ageing analysis: As above
- Write-off policy: 180 days overdue
- Credit risk concentration: Retail customers
- Changes in ECL: Increase due to economic downturn

QUESTION 2 — LIQUIDITY RISK (15 marks)

Scenario:

ABC Ltd has the following financial liabilities:

- Trade payables: R 600 000 (due within 6 months)
- Bank loan: R 4 000 000 (repayable over 4 years)
- Interest payable annually: R 200 000

Required:

Prepare the IFRS 7 liquidity risk maturity analysis.

Solution:

Period	Cash Outflow
< 6 months	R 600 000
1 year	R 200 000
1–2 years	R 1 000 000
2–3 years	R 1 000 000
3–4 years	R 1 000 000
4–5 years	R 1 000 000

QUESTION 3 — MARKET RISK SENSITIVITY (20 marks)

Scenario:

ABC Ltd holds:

- Equity shares at FVTPL: R 900 000
- USD receivable: USD 50 000 (exchange rate: R 18.00/USD)
- Variable-rate loan: R 2 000 000 (interest rate: 10%)

Required:

Prepare sensitivity analyses for:

1. Equity price risk (10%)
2. Currency risk (10%)
3. Interest rate risk (1%)

Solution:

1. Equity price risk

- ➔ 10% increase → gain R 90 000
- ➔ 10% decrease → loss R 90 000

2. Currency risk

USD receivable = 50 000 × 18 = R 900 000

- ➔ 10% increase in USD → R 990 000 → gain R 90 000
- ➔ 10% decrease → R 810 000 → loss R 90 000

3. Interest rate risk

Loan: R 2 000 000; 1% change → R 20 000 impact on profit

QUESTION 4 — FAIR VALUE HIERARCHY (20 marks)

Scenario:

ABC Ltd holds:

- Listed shares: R 700 000
- Government bonds valued using observable yield curves: R 2 000 000
- Unlisted shares valued using net asset value: R 500 000

Required:

Classify each instrument into Level 1, 2, or 3 and prepare IFRS 7 disclosures.

Solution:

- Listed shares → **Level 1**
- Government bonds → **Level 2**
- Unlisted shares → **Level 3**

Disclosures include:

- Valuation techniques
- Inputs used
- Transfers between levels
- Sensitivity for Level 3