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## NEW REVENUE MODEL AND PROGRESS ON ENHANCING DISCLOSURES

Welcome to the Q3 2014 issue of our quarterly banking newsletter in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.

### Highlights

- The IASB issues the **complete IFRS 9 Financial Instruments**, which is effective for annual periods beginning on or after 1 January 2018 – see page 2.
- The new **revenue recognition model under IFRS 15 Revenue from Contracts with Customers**: We discuss potential impacts on banks – see page 5.
- **How do you compare?** We have looked at 15 banks reporting under IFRS and compared the location and frequency of publication of their **Pillar 3 disclosures** – see page 12.
- The **EDTF issues its 2014 report** on banks' progress in implementing its 2012 recommendations, noting that significant progress has been made – see page 14.



# IASB ACTIVITIES AFFECTING YOUR BANK

## Complete IFRS 9 finally issued

On 24 July 2014, the IASB issued the complete IFRS 9 *Financial Instruments*.<sup>1</sup> This marks the culmination of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*, which was launched in 2008 in response to the financial crisis. The new standard includes revised guidance on the classification and measurement of financial assets, including impairment, and supplements the new hedge accounting principles published in 2013. It carries forward from IAS 39, without substantive amendment, the requirements on recognition and derecognition.

The standard is effective for annual periods beginning on or after 1 January 2018, and is applied retrospectively with some exemptions. Early adoption is permitted. The restatement of prior periods is not required, and is permitted only if information is available without the use of hindsight.

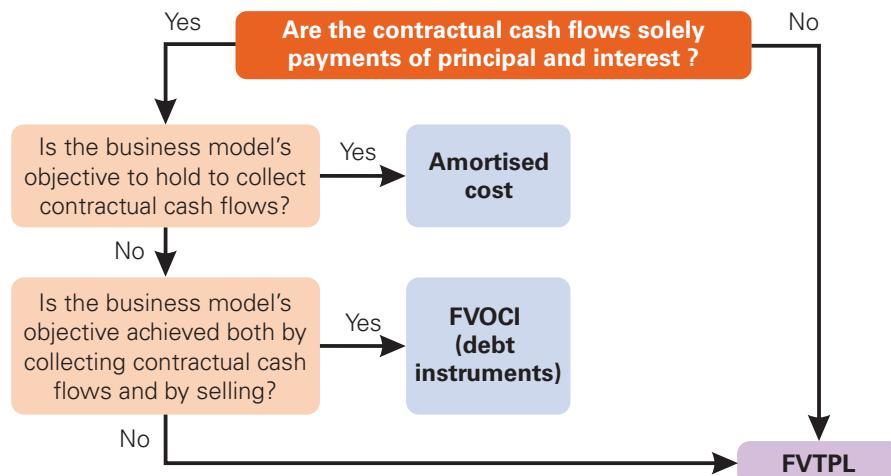
The IASB has carved out its deliberations on macro hedge accounting as a separate project. In April 2014, it issued a discussion paper DP/2014/1.<sup>2</sup>

Convergence between the IASB and the FASB has not been achieved. The FASB is continuing to deliberate changes to the accounting for financial instruments under US GAAP.

We outline below the requirements of IFRS 9 on classification and measurement, and impairment.

### Classification and measurement

Although the permissible measurement bases for financial assets – amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit and loss (FVTPL) – are similar to those under IAS 39, the new criteria for classification into the appropriate measurement category are significantly different, as illustrated by the diagram below. Embedded derivatives are no longer separated from financial asset hosts; instead, the entire hybrid instrument is assessed for classification.



In addition:

- for a non-trading equity instrument, a company may elect to irrevocably present subsequent changes in fair value in other comprehensive income (OCI). These are not reclassified to profit or loss under any circumstances; and
- if classifying a financial asset at amortised cost or at FVOCI would create an accounting mismatch, then a company can make an irrevocable election to classify it as at FVTPL if this would reduce the mismatch.

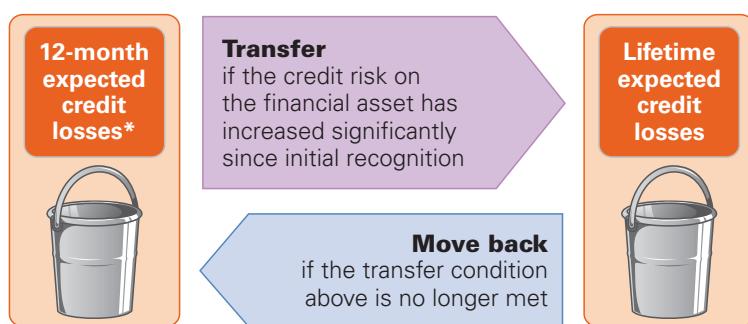
1. See our [First Impressions: IFRS 9 Financial Instruments](#), September 2014.

2. For a detailed analysis of the discussion paper, see our [New on the Horizon: Accounting for dynamic risk management activities](#), July 2014.

For the classification and measurement of financial liabilities, IFRS 9 retains almost all of the existing requirements from IAS 39. However, the gain or loss on a financial liability designated at FVTPL that is attributable to changes in its credit risk is usually presented in OCI; the remaining amount of change in fair value is presented in profit or loss.

### Impairment

IFRS 9 replaces the 'incurred loss' model in IAS 39 with an expected loss model. This means that a loss event will no longer need to occur before an impairment allowance is recognised. In general, the expected credit loss model uses a dual measurement approach, as follows.



\* 12-month expected credit losses are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

If the credit risk of a financial asset has not increased significantly since its initial recognition, then the financial asset will attract a loss allowance equal to 12-month expected credit losses. If its credit risk has increased significantly, then it will attract an allowance equal to lifetime expected credit losses, thereby increasing the amount of impairment recognised. However, the standard does not define what is meant by 'significant' – so judgement will be needed to determine whether an asset should be transferred between these categories.

The new model applies to financial assets that are:

- debt instruments recognised on-balance sheet, such as loans or bonds; and
- classified as measured at amortised cost or at FVOCI.

It also applies to certain loan commitments and financial guarantees.

A simplified approach is available for certain trade and lease receivables and for contract assets. Special rules apply for assets that are credit-impaired on initial recognition.

## Measuring the fair value of investments in subsidiaries, JVs and associates

There has been diversity in practice regarding the unit of account used to measure the fair value of investments in subsidiaries, joint ventures (JVs) and associates: the investment as a whole or the individual shares making up the investment. In an attempt to introduce clarity, on 16 September 2014 the IASB published an exposure draft<sup>3</sup> dealing with investments in subsidiaries, JVs and associates that are quoted in an active market – i.e. Level 1 instruments in the fair value hierarchy under IFRS 13 *Fair Value Measurement*.

This issue is important because if the unit of account is an individual share, then it cannot be argued that a premium or discount related to the size of the holding – e.g. a control premium – should be included in the measurement of fair value. However, if the unit of account is the investment as a whole, then it may be appropriate to add a control (or other) premium.

3. ED/2014/4 *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value (Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28 and IAS 36 and Illustrative Examples for IFRS 13)*. See our [In the Headlines – Measuring the fair value of investments in subsidiaries, JVs and associates](#), September 2014.

### **Fair value of quoted investments**

Under the proposals, the unit of account for such investments would be the investment as a whole. However, fair value would still be measured as the product ( $P \times Q$ ) of the quoted price of the financial instrument (P) and the quantity (Q) of instruments held. The Board's reasoning is that fair value measurements are more relevant, objective and verifiable when they are based on unadjusted Level 1 inputs.

### **Implications for fair value measurements of unquoted investments**

If the investment is not quoted, then fair value would be based on an exit price for the whole investment – i.e. the size of the investment could affect the fair value measurement if a market participant would consider it to be a relevant characteristic in pricing the investment.

### **Example added for portfolio measurement**

If certain conditions are met, then IFRS 13 permits an entity to measure the fair value of a group of financial assets and financial liabilities with offsetting risk positions on the basis of its net exposure. The proposals illustrate the measurement of a group that comprises only financial instruments with offsetting market risks that are all quoted in an active market. In the example, fair value is measured based on the Level 1 prices of the instruments that make up the net risk exposure. Therefore, under the proposals it would not be acceptable to adjust the fair value of such a portfolio's net exposure for premiums or discounts.

Comments are due to the IASB by 16 January 2015.

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## **Classification of a hybrid financial instrument by the holder**

In July 2014, the IFRS Interpretations Committee considered a request to clarify the classification by the holder of a hybrid financial instrument whose issuer has an option to extend maturity, settle early and/or suspend interest payments. The question raised by the submitter was whether the holder of the instrument should be classified as equity or debt.

On the basis of the responses to the outreach request, the Committee observed that the issue is not widespread. It also noted that the financial instrument described in the submission is specific and it would not be appropriate to provide guidance on this particular issue.

Consequently, the Committee decided not to add this issue to its agenda.

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## **Exchange of equity instruments**

Also in July 2014, the IFRS Interpretations Committee considered a submission about the accounting by the holder of equity instruments when the issuer exchanges its original equity instruments for new equity instruments in the same entity but with different terms. Specifically, this transaction involved equity instruments issued by a central bank and the exchange of instruments was imposed on the holders as a consequence of a change in legislation. The question was whether the holders of the equity instruments should account for this exchange as a derecognition of the original equity instruments and the recognition of new instruments.

The Committee observed that:

- because of the unique nature of the transaction, the issue is not widespread; and
- the submitter had not identified significant diversity in accounting for this transaction among the holders of the equity instruments in question.

For these reasons, the Committee decided not to add this issue to its agenda.

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# IFRS 15: POTENTIAL IMPACTS ON BANKS

“ Although at the moment the focus of banks reporting under IFRS is on the recently issued IFRS 9, the new standard on revenues is also likely to shape banks' accounts because of its potential impact on the amount and timing of revenue recognition. ”

**Editorial by Enrico Di Leo and Giorgio Vergani, Accounting Advisory Services, KPMG in Italy**

In May 2014, the IASB and the FASB published a new joint standard on revenue recognition, which replaces most of the detailed guidance on revenue recognition that currently exists under US GAAP and IFRS. The new requirements will affect different companies in different ways. This article highlights certain key impacts that will be of particular interest to those in the banking sector.

Although at the moment the focus of banks reporting under IFRS is on the recently issued IFRS 9, IFRS 15 *Revenue from Contracts with Customers* is also likely to shape banks' accounts because of its potential impact on the amount and timing of revenue recognition.

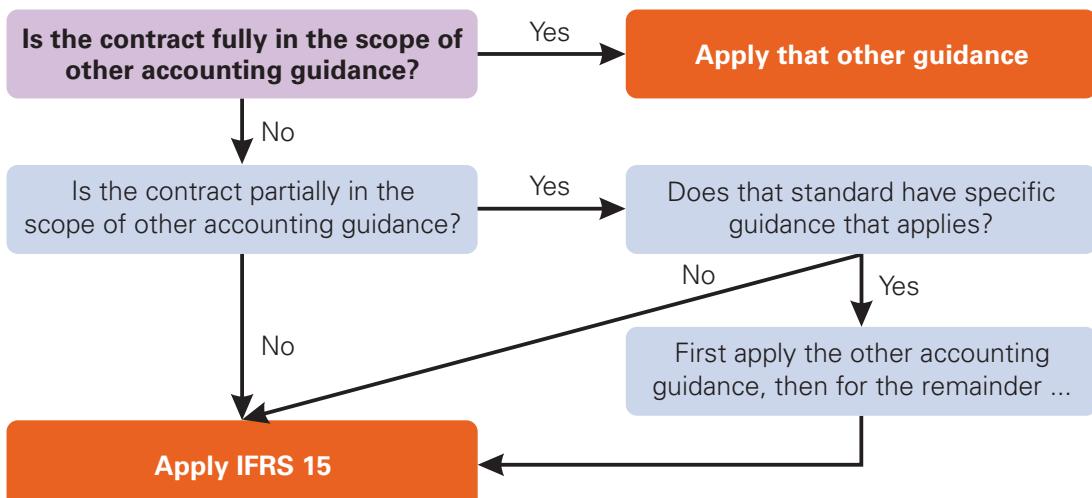
IFRS 15 is more prescriptive than current guidance in some areas relevant to banks, and also introduces new guidance – e.g. on accounting for variable consideration and capitalising costs to obtain a contract. It may therefore require banks to modify their current accounting policies.

Although IFRS 15 is not effective until January 2017, banks should not delay assessing its impact. Applying the guidance in certain areas is complex, requiring new estimates and the exercise of significant judgement. In addition, the new qualitative and quantitative disclosure requirements are extensive and may require changes to systems and processes to collect the necessary data.

One key decision that needs to be made soon is how to make the transition to the new standard. Banks need to evaluate the wide range of transition options available, which include fully retrospective application, partial retrospective application (with three optional practical expedients), and the cumulative effect method with no restatement of comparative information.

## ***Is the item of revenue in the scope of IFRS 15?***

IFRS 15 applies to a wide range of revenues typically generated by a bank, most of which are presented in the statement of profit or loss as fees and commissions or other income. However, certain contracts are outside its scope (e.g. leases or financial instruments in the scope of IFRS 9) and certain contracts may be partially in the scope of IFRS 15 and partially in the scope of another standard. The diagram below illustrates how to determine whether IFRS 15 applies to a particular contract.



Sometimes, after accounting for part of a transaction under another standard, banks may identify only minimal consideration that would fall under IFRS 15. The residual amount to be accounted for under IFRS 15 may be zero in some cases. For example, a bank may enter into a contract with a customer in which it receives a cash deposit and provides treasury services for no additional charge. The cash deposit is a liability in the scope of financial instruments guidance and therefore the initial recognition and measurement requirements in the financial instruments guidance are

applied to measure the cash deposit. The residual amount, if there is any, is then allocated to the treasury services and accounted for under IFRS 15. Because in this example the full amount received for the cash deposit is recognised as a deposit liability, there are no remaining amounts to allocate to the treasury services.

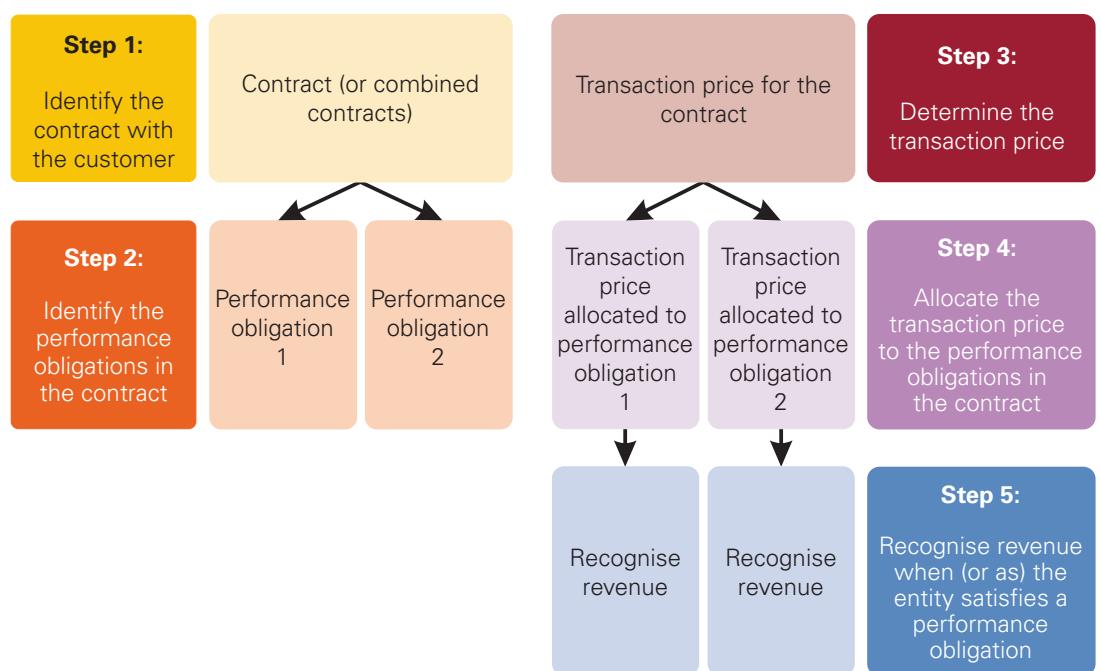
Guidance currently included in the illustrative examples to IAS 18 *Revenue*, relating to fees that are an integral part of the effective interest rate of a financial instrument, has been transferred to IAS 39/IFRS 9 as part of the consequential amendments and is not included in IFRS 15. Fees that are not an integral part of the effective interest rate are accounted for under IFRS 15. These include:

- fees charged for servicing a loan;
- commitment fees to originate a loan when the loan commitment is outside the scope of IAS 39 or IFRS 9 and it is unlikely that a specific lending arrangement will be entered into; and
- loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

### ***Understanding the new model***

IFRS 15 introduces a five-step model to determine when to recognise revenue, and at what amount. The model specifies that revenue should be recognised when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled. Depending on whether certain criteria are met, revenue is recognised:

- over time, in a manner that depicts the entity's performance; or
- at a point in time, when control of the goods or services is transferred to the customer.



IFRS 15 also provides guidance on when to capitalise the costs of obtaining a contract, and the costs of fulfilling a contract that are not in the scope of other accounting standards.

In the following sections, we focus on some of the sectors and transactions that may be impacted and provide examples to illustrate the impact. Lastly, we provide an example of the application of the five-step model to a typical agency contract between banks and insurance companies.

## **Potential impact on investment management**

### **Variable fees**

In the investment management and private equity sectors, variable consideration contracts that include performance and bonus fees are common. For example, an investment manager may provide asset management services to a customer in exchange for a performance incentive fee based on the portfolio's return in excess of the return of an observable market index over that period.

IFRS 15 introduces specific guidance on determining how much variable consideration to include in the transaction price. An entity estimates the amount of variable consideration by using either the 'expected value method' or the 'most likely amount method', depending on which method is expected to better predict the amount of consideration to which the entity will be entitled. However, this amount is subject to a 'constraint' and only included in the transaction price to the extent that is 'highly probable' that a significant revenue reversal will not subsequently occur. To assess whether – and to what extent – this constraint applies, an entity will need to use judgement and consider the impact of external factors such as market volatility.

An illustrative example<sup>4</sup> included in IFRS 15 concludes that the investment management company cannot include a performance-based incentive fee in the transaction price until the contingency is resolved because the promised consideration is dependent on a market index and is therefore highly susceptible to factors outside the entity's influence. Furthermore, the investment management company's previous experience and the past performance of the market index are of little predictive value in determining the future performance of the market.

However, this conclusion may differ depending on specific facts and circumstances. An asset manager is not precluded from recognising a portion of a performance-based incentive fee before the contingency is resolved, if it is highly probable that there will not be a significant revenue reversal when the uncertainty is resolved. For example, if the asset manager locks in the performance fee before the end of the contract period by investing the managed funds in money market investments, and intends to hold the managed funds in money market investments until the end of the contract period, then the asset manager may be able to recognise a portion of the performance fees before the end of the contract period.

### **Up-front fees**

In the investment management sector, entities often receive non-refundable up-front fees at or near contract inception. Under IFRS 15, an entity will need to assess whether the fee relates to a specific good or service transferred to the customer – in which case, consideration will be allocated to the good or service and revenue recognised when or as it is transferred. For example, up-front fees may relate to the use of a safe deposit box during the contract term, and the entity may determine that the safe deposit box services represent a separate performance obligation. However, in many cases, even though a fee may relate to an activity that the entity is required to undertake in order to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer – e.g. setting up the customer in the entity's systems. Instead, the fee represents an advance payment for future goods or services and, therefore, under IFRS 15 revenue is recognised when those future goods or services are provided.

There are also cases in which customers are not charged fees for the services provided. For example, when the volume of customer assets under management is particularly high, an investment company or bank may offer certain services as a marketing tool to attract new customers. In these cases, the entity should assess whether the free services provided meet the definition of a performance obligation under IFRS 15. If the entity concludes that the services are a separate performance obligation, then a portion of the consideration that the bank is entitled to will be allocated to the services accordingly.

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4. Example 25 in IFRS 15: Management fees subject to the constraint.

### **Costs to obtain a contract – Success fees**

IFRS 15 provides specific guidance on accounting for the costs of obtaining a contract and certain costs to fulfil a contract. Incremental costs to obtain a contract are required to be capitalised if the entity expects the costs to be recoverable and the amortisation period is more than 12 months. This may be particularly relevant in the investment management sector because significant commissions are often paid – e.g. to brokers or agents – when a new contract is signed.

Capitalised costs are amortised on a systematic basis, consistent with the pattern of transfer of the service or product to which the asset relates, and are subject to impairment testing. The amortisation period may include an anticipated future contract – e.g. anticipated contract renewal periods. Entities will need to apply judgement in determining the appropriate amortisation basis and time period.

### **Potential impact on consumer banking**

#### **Customer options for additional goods or services – Credit card loyalty programmes**

A bank may offer a customer the option to acquire additional goods or services for free or at a discount, customer loyalty points or other discounts on future goods or services. IFRS 15 does not provide any specific guidance on its application to credit card loyalty programmes – and additional complexities can arise with such programmes, because there are typically at least three parties involved: the card issuer, a retailer and the end customer. Therefore, judgement will be required to determine whether a credit card loyalty programme gives rise to a performance obligation of the card issuer. If it does, then a portion of the interchange fee will need to be allocated to the performance obligation, based on the relative stand-alone selling price of the loyalty points, and deferred until redemption occurs.

### **Potential impact on other banking sectors**

#### **Bundled products or services**

Banks often offer to customers bundled products that integrate different services in a single package or contract – e.g. mortgages and unemployment protection insurance policies, or mortgages and estate investment services such as market analysis and consultancy services.

Similarly, investment banks involved in an initial public offering (IPO) process may offer a number of services within the same contract, such as arranging the deal, underwriting, organising road shows and other marketing initiatives.

In these cases, banks will need to first identify whether a contract, or part of the contract, is in the scope of IFRS 15. If it is, in whole or in part, then the bank will need to identify the performance obligations and allocate the transaction price to each performance obligation in proportion to its stand-alone selling price. IFRS 15 states that the best evidence of the stand-alone selling price is an observable price. However, it provides guidance on estimating prices when they are not directly observable. Banks that engage in such transactions will need to develop new processes, including appropriate internal controls, for estimating the stand-alone selling prices of goods or services that are not typically sold separately.

## Bank-assurance agreements

This example illustrates how the IFRS 15 five-step approach to recognising revenue may be applied in practice.

### Example – Applying the five-step model

Bank B sells to its customers, through its branches, insurance products on behalf of Insurance Company X. Under the agreement between B and X, B promises to provide three types of services, as follows:

- a. acquisition of new clients in exchange for a fixed fee to be paid by X on the signing of a new insurance product;
- b. collection of successive annual premiums, renewals, one-off payments etc in exchange for fees that are paid by X over time, once the contract is renewed or premiums collected; and
- c. consultancy and post-sale services provided to customers in exchange for fees that are paid up-front; however, based on the premium reimbursements that customers are entitled to claim due to contract or law provisions, B may have to refund part of those fees to X.

#### Step 1

Under Step 1 of the model, B determines that its agreement with X creates enforceable rights and obligations based on the following:

- both parties have approved the contract, either in writing, orally or in accordance with other customer business practices;
- the rights to goods and services and the payment terms are identified in the contract;
- the contract has commercial substance; and
- collection of the consideration from X is probable.

#### Step 2

B assesses the services promised in the contract with X and identifies the performance obligations. This requires assessing whether the services that it has promised to transfer are distinct. In this example, X can benefit from each service to be provided by B on its own, indicating that they are separate performance obligations. However, IFRS 15 contains a second criterion that must be met, which requires B's promise to transfer each service to be separately identifiable from the other services promised. Depending on the specific facts and circumstances, Services (b) and (c), for example, may be more or less inter-related, which may lead to the conclusion that (b) and (c) constitute a single performance obligation.

In this example, assume that B concludes that there are two performance obligations. Service (a) is identified as a distinct performance obligation – i.e. the acquisition of new clients and services. Services (b) and (c) represent a combined output for which X has contracted – i.e. the bank's ability to provide ongoing services to customers – and therefore the combined bundle is a performance obligation.

### Step 3

In this example, Step 3 is a critical one, especially if we look at Service (c). The transaction price is the amount of consideration to which B expects to be entitled in exchange for transferring the service to X. When establishing the amount of consideration, B will have to consider the risk and magnitude of revenue reversal that the premium reimbursements claimed by customers may generate. Depending on the specific facts and circumstances, this estimate may require a higher or lower degree of judgement and complexity (e.g. forecasts of the amount of premium cancellations could also mean estimating customers' behaviour) and different estimation methods (i.e. the expected value or the most likely amount). Based on this estimate, the revenue will be recognised only up to the constrained amount and there will be a net contract asset or liability depending on the balance of performance under the contract.

### Step 4

Once the transaction price is determined, it will be allocated to the performance obligations in the contract based on their stand-alone selling prices.

### Step 5

B will recognise revenue when or as it provides the services to X. In this example, Service (a) is satisfied at a point in time because X benefits from the service only when a client signs a new contract – i.e. X benefits from B's performance only when the performance obligation is satisfied. However, Services (b) and (c) are satisfied over time, because X simultaneously receives and consumes the benefits of the services that B provides to its existing customers.

### What if B and X belong to the same group?

It's important to note that if the insurance company and the bank belong to the same group, then the application of IFRS 15 may have an impact on the consolidation process because those services are carried out within the same group. Looking at Service (a), for example, X would capitalise the fee paid to B as a cost of obtaining a new contract, whereas B would recognise the fee as revenue when it is paid. This would create consolidation reconciling items that would require updating of processes and policies.

### New disclosure requirements

Under IFRS 15, banks will need to disclose more information about their contracts with customers than is currently required, including disaggregated information about revenue and information about the performance obligations remaining at the reporting date.

Although IFRS 15 does not prescribe a minimum number of disaggregation categories, banks will need to evaluate what categories are needed in order to depict the economic factors affecting the nature, amount, timing and uncertainty of revenue and cash-flows. The new disclosure requirements are likely to have a significant impact on banks.

Banks will need to evaluate the level of granularity required to achieve the new disclosure objective. Depending on the specific facts and circumstances, this may involve explaining the bank's business model in more detail. However, for interim reporting IFRS preparers only need to disclose a disaggregation of revenue and then follow IAS 34 *Interim Financial Reporting* to determine whether any other disclosures are required.

### Further implications

The shrinking interest margin that banks have experienced in recent years due to the general low interest rate environment – which has affected some countries more than others – has increased the importance of other sources of income for banks' profits, leading banks to increase their offer of integrated services. The sales-channels of many banks are more often used to sell not just

financial services but also commercial goods – e.g. mobile phones and other IT tools. Furthermore, many banking groups own huge IT service providers that are essential for running the banking business. They often produce IT applications and deliver a wide range of different services within and outside the group. These types of business are likely to be more significantly impacted by IFRS 15.

Banks will also need to evaluate these aspects of their business when planning their transition to IFRS 15.

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# HOW DO YOU COMPARE? PILLAR 3 DISCLOSURES

**Although Pillar 3 disclosure is made for regulatory purposes, some information overlaps with that required for financial reporting.**

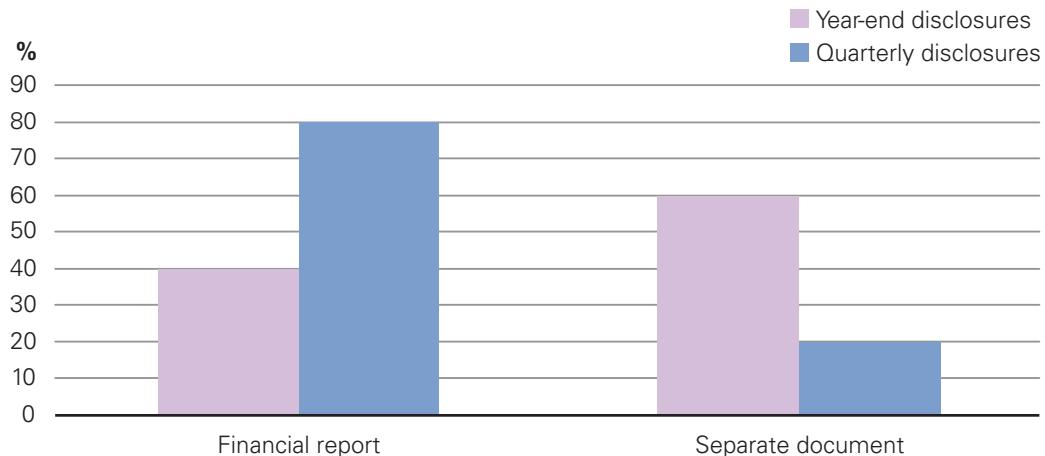
In this issue, we look at the location and frequency of disclosure of Basel Pillar 3 information. We looked at 15 European banks with international operations that report under IFRS and reviewed the information disclosed in their annual financial statements for the year ended 31 December 2013 and in quarterly reporting during 2014. Although Pillar 3 disclosure is made for regulatory purposes, some information overlaps with that required for financial reporting and many banks chose to disclose the information as part of their annual reports.

In future, the manner in which Pillar 3 disclosure is made may change following the recent proposals issued by the Basel Committee on Banking Supervision (BCBS) – see page 17.

## **How many banks disclosed Pillar 3 information separately from their financial reports?**

The current Pillar 3 regime offers banks discretion to determine the appropriate location for disclosures.

The chart below summarises where banks in our sample disclosed Pillar 3 information.<sup>5</sup>



For year end disclosures, most banks chose to present Pillar 3 disclosures in a separate document. Banks that disclosed the information in their annual reports generally included it outside the audited financial statements, primarily in the risk section of the management report. However, some banks that made Pillar 3 disclosures outside their audited financial statements included in them certain audited disclosures that are also required by IFRS 7 *Financial Instruments: Disclosures*. Some banks disclosed certain specific information within the audited financial statements and cross referred to it from other Pillar 3 disclosures – e.g. information about remuneration, whereas some other banks provided the same information twice: within and outside of the audited financial statements. Many banks disclosing Pillar 3 within their financial reports provided a navigation tool or cross-references to distinguish between Pillar 3 and other types of disclosure – e.g. those required by IFRS or recommended by the Enhanced Disclosures Task Force (EDTF).

For the quarterly reports, a large majority of banks opted to disclose Pillar 3 information as part of their financial reporting. Generally, banks disclosing financial and Pillar 3 information in the same document at year end followed the same approach for quarterly reports.

5. Three banks reported financial and Pillar 3 disclosures together only in the registration document.

### ***Frequency***

All banks in the sample provided Pillar 3 information quarterly. At year end, they disclosed quantitative information (e.g. capital adequacy and risk-weighted assets) and qualitative information (e.g. risk management objectives and strategy, governance and policies). Information disclosed quarterly varied in the level of detail. Approximately half of the banks gave both qualitative and quantitative disclosures in their half-year reporting, although generally in less detail than at year end. Most banks disclosed only quantitative information in other quarters.

### ***Reconciliation with accounting information***

All banks in our sample provided in their year end Pillar 3 disclosures reconciliations between IFRS and the regulatory scope of consolidation. However, only a small number provided reconciliations between their IFRS balance sheet and regulatory exposures subject to credit risk calculations.

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# REGULATION IN ACTION: IMPLEMENTATION OF THE EDTF RECOMMENDATIONS

**Many banks have made big steps forwards in improving disclosures but there is still room for improvement.**

The banking sector continues to take steps to improve investor confidence in financial reports. The EDTF has issued its second progress report on implementation of the recommendations it made in 2012.<sup>6</sup> The report looks at disclosures in the 2013 annual reports of 41 systemically important banks, including 29 global systemically important banks. The level and quality of disclosures was analysed from two perspectives:

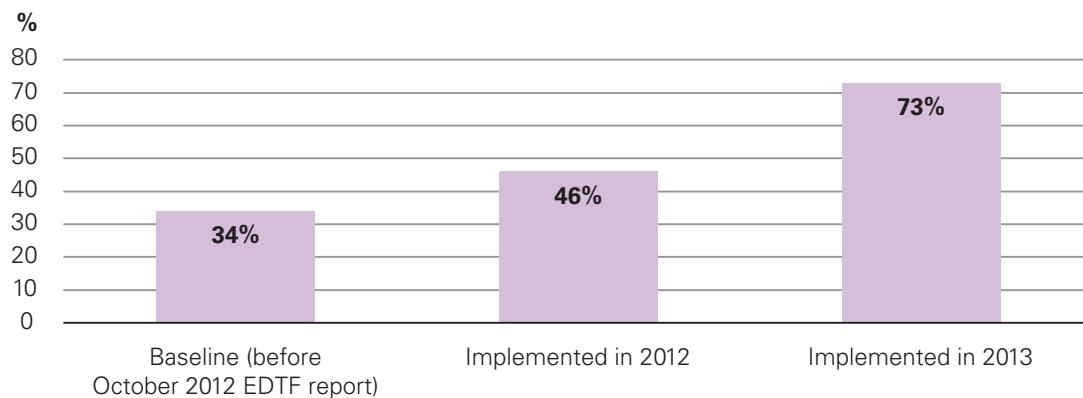
- survey responses from banks on which recommendations they believed they had fully or partially implemented; and
- a review of disclosures by members of the EDTF who are active users of financial information published by banks (the user group).

## **Levels of implementation have increased**

The participating banks assessed that they have implemented 73 percent of the information in the EDTF's 32 recommendations, 27 percentage points more than in the previous year. Disclosures about capital, market risk, liquidity and funding were among those with the largest reported increase in implementation from the previous year.

The user group reviewed implementation of 18 of the recommendations included in the 2012 report and concluded that 50 percent had been fully implemented and 29 percent partially implemented – compared with 68 percent and 19 percent respectively as assessed by banks themselves. Although both banks and the user group have concluded that the level of implementation of the recommendations has increased compared with the previous review, a gap persists between the banks' self assessments and the assessments of the user group.

## **Aggregate implementation of EDTF recommendations**



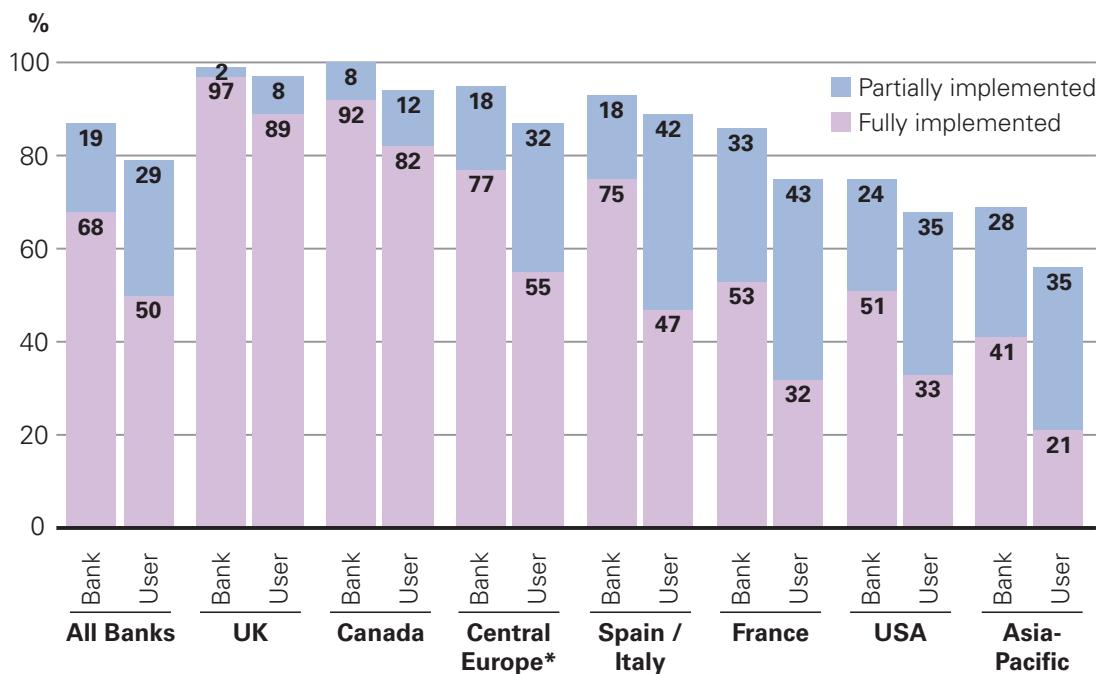
## **Implementation varies by region**

The progress report notes that banks in the UK and Canada have fully implemented the overwhelming majority of the recommendations. However, implementation rates were lower and differences between the self-assessment and the user group assessment wider in the US and parts of Europe. The report notes that support from local regulators impacts the extent of implementation.

6. The Financial Stability Board's (FSB) EDTF issued its report *Enhancing Risk Disclosures of Banks* in October 2012; see our [In the Headlines – FSB Enhanced Disclosure Taskforce publishes its recommendations for banks](#), October 2012.

The diagram below, reproduced from the progress report, gives more detail on the level of adoption of the EDTF recommendations in the different regions and from the two different perspectives – i.e. banks and users.

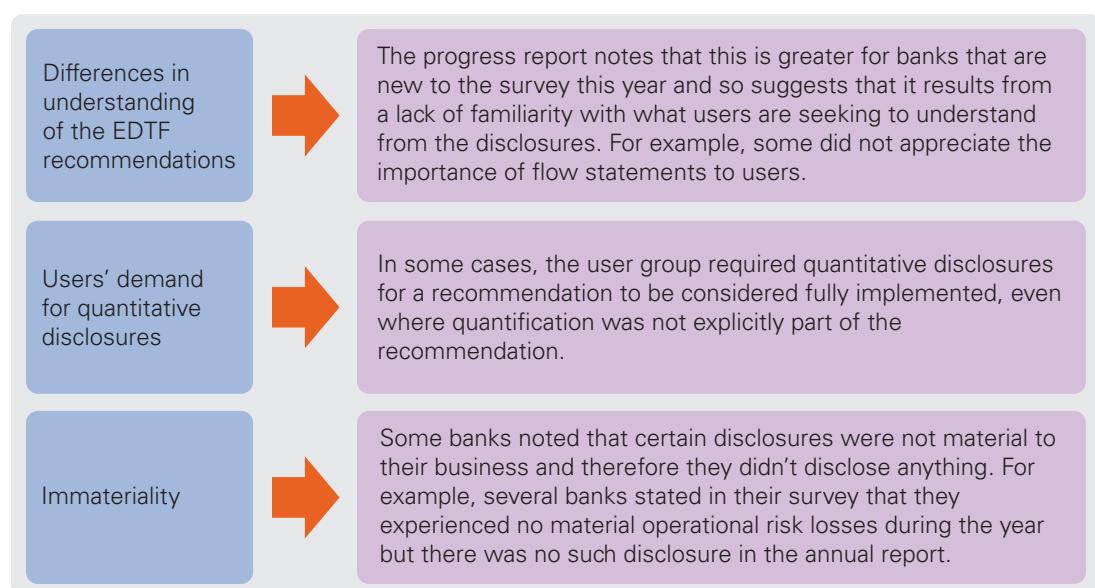
### Implementation by geography



\* Central Europe includes Germany, the Netherlands, Sweden and Switzerland

### Key reasons for differences between users' and banks' assessments

The progress report notes the following key reasons for the difference between assessments by users and banks.



Many banks reported having devoted considerable time and resources to implementing the EDTF recommendations during 2013. Eighty-four percent reported that senior executives – e.g. chief executive officer, chief financial officer and chief risk officer – had a ‘high’ level of involvement in setting implementation approaches, and 54 percent reported that board members had also been involved.

### **Lessons learned**

The progress report provides additional feedback on lessons learned to date in reviewing the implementation of the recommendations. It provides more guidance on the following areas of recommended disclosures:

- risk governance and risk management strategies;
- capital adequacy and risk-weighted assets;
- funding;
- market risk; and
- other risks.

The progress report encourages smaller banks and subsidiaries of listed banks to adopt the recommendations that are considered relevant to them, noting that understanding group structures and the specific risks arising within subsidiaries are likely to become increasingly relevant as recovery and resolution and ring fencing initiatives are finalised.

### **Next steps**

Although banks have made significant progress in implementing the EDTF’s recommendations – and implementation is nearly complete in some jurisdictions – the FSB and the EDTF both believe that there is still work to be done in supporting this initiative and exploring new ways to refine and update its recommendations in the future.

Going forward, the EDTF plans to:

- play a role in keeping the sector alert to risks and issues that may benefit from enhanced disclosure;
- monitor the BCBS’s review of Pillar 3 disclosure requirements (see page 17); and
- follow developments in the implementation of the new standards from the IASB and the FASB on financial instruments and the new credit risk disclosures that may result.

# WHERE REGULATION AND REPORTING MEET ...

## BCBS reviews Pillar 3 disclosure requirements

In June 2014, the BCBS issued a consultative document, *Review of the Pillar 3 disclosure requirements* (the proposals). The BCBS explains that the review was needed because "the existing Pillar 3 framework failed to promote the early identification of a bank's material risks and did not provide sufficient information to enable market participants to assess a bank's overall capital adequacy".

Although Pillar 3 disclosures are made for regulatory purposes, there is a linkage to the disclosure requirements in financial statements and some banks choose to make Pillar 3 disclosure in their financial reports.

### **Overview of the proposals**

The proposals discuss the following topics:

- format of Pillar 3 reporting;
- scope of application, frequency and timing;
- consistency and comparability;
- linkage with accounting information;
- maintaining validity of Pillar 3 disclosures; and
- assurance of Pillar 3 data.

The BCBS states that, for the most part, the proposals do not contain additional requirements but instead clarify the existing ones to improve consistency in implementation, and contain a common structure for disclosures. The aspects that may have particular relevance for financial reporting are discussed briefly below.

### **Reporting format**

The BCBS notes that risk and regulatory disclosures are currently spread across banks' financial reporting and Pillar 3 reports, often with a lack of clear signposting, which makes it difficult for users to locate disclosures and to navigate them. To address this issue, it proposes that banks publish their Pillar 3 disclosures in a separate document. The document could be appended to, or form a discrete section of, a bank's financial reporting, but it would have to be easily identifiable by users.

### **Frequency and timing of disclosures**

The review identified a lack of consistency in the timing and frequency of publication of Pillar 3 data. Therefore, the BCBS proposes greater prescription in both areas – for example:

- *capital calculations*: disclosure on a quarterly basis, irrespective of the bank's normal financial reporting schedule;
- *the majority of other quantitative requirements*: disclosure in line with the frequency of financial reporting; and
- *qualitative information*: annual disclosure.

The proposals set out the proposed frequency of reporting for each disclosure template proposed.

### **Consistency and comparability**

The BCBS notes that its review identified different practices over the granularity of data disclosed and lack of consistency in a number of areas. To address this issue, the BCBS proposes greater use of templates and standardisation of a number of key definitions.

### Linkages with accounting information

The BCBS also notes that it is currently difficult for users to understand differences between line items in banks' financial statements and Pillar 3 disclosures. It notes that certain banks provide some comparison, which it regards as best practice. It therefore proposes a template to map line items in a bank's financial statements to the exposure amounts used in its Pillar 3 reports.

### Next steps

The BCBS review is divided into two phases. The focus of this first phase (and of the report issued in June 2014) is on the disclosure requirements in the areas of credit, market and counterparty credit risks, as well as equity risk and securitisation. Disclosures for other risk elements – i.e. interest rate risk in the banking book and operational risk – will be considered in phase two.

The comment period for the proposals will end on 10 October 2014. Banks will be required to comply with new requirements from their first reporting period on or after 1 April 2016.

### EBA advises on the prudential filter for fair value gains and losses arising from own credit risk related to derivative liabilities

On 30 June 2014, the European Banking Authority (EBA) published technical advice on the prudential filter for fair value gains and losses arising from the institution's own credit risk related to derivative liabilities.<sup>7</sup> Under the Capital Requirements Regulation (CRR), European institutions are not allowed to include in own funds fair value gains or losses arising from changes in their own credit standing. However, the CRR does not contain guidance on how to measure own credit risk, and the measurement is performed on the basis of the accounting framework. The implementation of IFRS 13 from 1 January 2013 impacted the measurement, so the technical advice explores the level of prudence of alternative methods of treating such gains and losses.

Although the analysis in the technical advice has been carried out for prudential purposes, it includes a discussion of the topic in the context of IFRS 13.

In conclusion, the EBA recommends not deviating from the prudential treatment that is currently applied at the international level under Basel III rules. However, it recommends a close monitoring of institutions' practices for measuring own credit risk.

### CFA Institute issues analysis

In July 2014, the Chartered Financial Analyst Institute (CFA Institute) issued a report *Financial Crisis Insights on Bank Performance Reporting*, released in two parts:

- Part I: assessing the key factors influencing price-to-book ratio; and
- Part II: relationship between disclosed loan fair values, impairments, and the risk profile of banks.

The report puts forward the following recommendations.

- Part I
  - *In addition to amortised cost carrying values, the fair value measurement of loans should be recognised on the face of the balance sheet*, especially because the study argues that the current requirements to provide only disclosures of fair values for loans do not ensure that these disclosed fair values are always prepared with the rigor that would ordinarily be applied for recognised financial statement information.
  - *Bank risk disclosures need continued enhancement*: Information risk contributes to investors' banking sector risk aversion. The report notes that, as has been recommended by numerous stakeholders, including the EDTF, risk disclosures need to be enhanced to help investors better understand bank business models and reduce the risk premium that investors assign owing to the limited transparency of banks' financial statements.

7. EBA/Op/2014/05.

- Part II

- *Enhance loan fair value disclosures*: The report argues that a key improvement would be to explain the differences between the carrying values and fair values that have been determined on the basis of the bank's internal model – i.e. Level 3.
- *Enhance loan impairment disclosures*: The report argues that improvements are required to allow greater understanding of the nature of impairment and thereby the sources of the differences in impairment charges and allowances for loan losses among banks.
- *Strengthen regulatory monitoring and enforcement activities across countries*: The report recommends that securities regulators continually monitor reporting practices by banks and encourage consistent and comparable reporting. It notes that this recommendation was also made by the European Securities and Market Authority (ESMA) in its review of EU banks' 2012 reporting.

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