Reporting of credit risks arising from investments and accounts receivable
Supervision of Financial Reporting

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The Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers’ and companies’ confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.
1 Management summary

The thematic review ‘Reporting of credit risks arising from investments and accounts receivable’ was conducted mainly as a result of the current economic climate. The AFM wishes to establish by means of this thematic review whether companies present a true picture of the composition and quality of their accounts receivable and investments, and the risks to which they are exposed. This review thus has a wider scope than the review conducted in 2012 of the ‘Measurement and transparency of bonds and other positions in countries with sovereign risk’.

The thematic review was conducted on a selection of companies subject to supervision which can be divided into the following categories on the basis of their activities and the nature of their accounts receivable and investments:

- banks and insurers
- trading and industrial companies

The AFM’s findings are as follows:

- Banks/insurers generally provide extensive information on their accounts receivable and investments, however transparency could be increased by introducing more structure (cohesion and reconciliation) in the disclosure;
- Banks provide little information on restructured loans (forbearance);
- The disclosure by banks/insurers of ‘assets held for sale’ could provide more information regarding the risks of impairment;
- Trading and industrial companies could improve their disclosures of credit quality and concentration risk;
- Banks provide little or no information on the assets that have not (or not yet) been provided as specific collateral.

Banks/insurers generally provide extensive information on their accounts receivable and investments, however transparency could be increased by introducing more structure (cohesion and association) in the disclosure

Most banks and insurers provide detailed information on accounts receivable and investments. Information on policy and procedures and the management of the associated credit risks is usually tailored to the specific company. Many quantitative disclosures are also provided.

There is room for further improvement with respect to transparency (and accessibility). Credit risks and items are disclosed from various perspectives in some cases, but the meaning of and relationship between these disclosures are not always clear. Reconciliation with the position in the statement of financial position cannot always be discerned, or at least not easily.
A logical sequence of the disclosures of maximum credit risk, credit quality, concentration risk, collateral and measurement in which the connections between these disclosures are clearly shown would increase the transparency of the disclosures as a whole. Currently, these disclosures frequently appear in different places, and the connection between and meaning of the disclosures are not always clear. The nature and meaning (in terms of risk management) of quantitative disclosures should be clear.

Important terms, such as ‘non-performing loans’, should be explained. In some cases more than one definition is given, for instance the internal and the prudential definition. The definition used in the disclosures to the financial statements should be made clear. It should also be explained whether the ‘general’ definition used is applied consistently in the various disclosures to the financial statements, or that the IFRS terms used have a different meaning.

Banks provide too little information on restructured loans (forbearance)
All or nearly all banks explain that they restructure loans if this represents the best possibility of collection. Only limited information is provided on the process of the restructuring and how impairments are dealt with. Only one bank discloses the amounts involved in these restructurings. In view of the current economic conditions, it is very important that more banks provide relevant information on restructured loans.

The disclosure by banks/insurers of ‘assets held for sale’ could provide more information regarding the risks of impairment
Changes in the value of financial assets held for sale are in the first instance recognised in equity. A positive or negative revaluation reserve is thus created. The movements in this revaluation reserve are rarely disclosed. A breakdown of the amount of the revaluation reserve is also not usually provided. It is therefore generally not clear to which assets a negative revaluation reserve applies on the balance sheet date. This disclosure is important for understanding the financial position and the likelihood of future impairment.

Trading and industrial companies could improve their disclosures of credit quality and concentration risk
The AFM sees a number of areas of potential improvement for trading and industrial companies, mainly in relation to the disclosure of credit quality and concentration risk. The reason why companies do not recognise a risk associated with the quality of the accounts receivable or their concentration risk is justified in only general terms in a number of cases. Nearly half of the companies do not recognise a concentration of credit risk, while their activities (for instance, reduced geographical or sectoral diversification) indicate that concentration, and the associated risk, has increased.
Banks provide little or no information on the assets that have not (or not yet) been provided as specific collateral

All or nearly all banks state the accounts receivable/investments they have provided as collateral for funding they have raised. On the other hand, it is often unclear what assets are still freely available for use as collateral. For investors, it is important to know which assets a bank has at its disposal to be able to raise additional liquidity without delay. The AFM sees room for improvement here.
2 Rationale, objectives and population

2.1 Rationale
The AFM notes that credit risks are increasing in the current economic climate. Companies are increasingly often unable to collect their accounts receivable. Financial institutions are exposed to the same increased risk with respect to their outstanding loans and investments. In addition, banks need to improve the statement of their equity position and take a critical view with regard to the risks of their assets. For investors, it is important to know what credit risks exist and how companies are managing them. In particular, investors want to know the extent to which the increased credit risks have affected the measurement of important items in the financial statements. A company should therefore provide adequate transparency on these items in its financial reporting.

2.2 Objective: to check whether companies provide adequate transparency
IFRS 7 is principle based, and requires that a company ‘shall disclose information that enables users (or investors) to evaluate the company’s financial position and performance and the risks associated with financial instruments to which the company is exposed at the end of the reporting period’. Companies interpret this principle in various ways, and therefore the disclosures provided do not always correspond to the wishes of the users (or investors). We have also taken account of these wishes in our review of the transparency provided by companies on the credit risks to which they are exposed. One of the references we have used in this context is the report by the Enhanced Disclosure Task Force (EDTF). This group was set up by the Financial Stability Board (FSB) and consists of investors, analysts, preparers, auditors and standard setters. In accordance with its mandate, the EDTF has made recommendations for increasing the level of transparency provided to investors in financial institutions and thereby to increase confidence in the sector. These recommendations were published in October 2012.

In this review, we have focused on the transparency provided by companies with respect to the quality of the assets in question, the measurement techniques and the risks to which they are exposed.

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1 This is evidenced for instance from the following reports by the CFA Institute:
http://www.cfainstitute.org/ethics/Documents/cfa_institute_user_perspectives_on_financial_instruments_under_ifrs.pdf and
The key objectives of the review are to obtain a picture of the quality of the disclosures of:

1. exposure to credit and investment risks, including credit quality and concentration risks;
2. impairments and the collateral obtained;
3. commonly used terms, such as ‘non-performing loans’ and ‘restructured loans’.

2.3 Population: 39 companies

The thematic review was carried out using the 2012 financial reporting of Dutch companies subject to supervision whose shares were admitted to trading on Euronext Amsterdam as of 31 December 2012. The review included all the banks (five), insurance companies (four), banks/insurers (two) and 28 non-financial institutions. The non-financial institutions selected are cyclical companies, and include construction companies and companies whose business is related to construction.
3  Key review results

We have divided the banks and insurers and the trading and industrial companies in this section, since their core activities vary. The core business of banks and insurers is to hold financial assets (loans and investments). In the case of trading and industrial companies, accounts receivable are more a product of their core business.

3.1  Banks and insurers

3.1.1  Banks/insurers generally provide extensive information on their accounts receivable and investments, however transparency could be increased by introducing more structure (cohesion and association) in the disclosure

Most banks and insurers provide detailed information on accounts receivable and investments. Information on policy and procedures and the management of the associated credit risks is usually also tailored to the specific company. Many quantitative disclosures are also provided. Certain aspects are disclosed in only qualitative terms, or ‘in the language of the standard’ in only a few cases.

The AFM notes that a clear definition of the terms used in the financial reporting, such as ‘non-performing loans’, NPL or NPL ratio is important and that this is often omitted. These terms can be explained in various ways, such as: loans with payments in arrears, loans for which a provision has been formed, restructured loans, or a combination of all three. In one single case, more than one definition is provided, although in this case it is not clear which definition applies in the disclosures.

There is room for further improvement with respect to transparency (and accessibility). Credit risks and items are disclosed from various perspectives in some cases, for example by sector, nature or rating, however the meaning of and relationship between these disclosures are not always made clear. The reconciliation with the position in the statement of financial position cannot always be discerned, or at least not easily. A logical sequence between and reference to the disclosures of maximum credit risk, credit quality, concentration risk, collateral and measurement would make the disclosure clearer.

The following findings and recommendations relate to the aspects involved in the evaluation of risks. These are the exposure to credit and concentration risk, the credit quality and the collateral.
Exposure to credit risk – reconciliation between the statement of financial position and the disclosures can be improved

There are two types of credit risk: the maximum exposure to credit risk without taking account of collateral, and net credit risk, in which collateral is taken into account (known as ‘exposure at default’).

Only a limited number of the banks and insurers present a total overview of their maximum exposure. This is an overview of every account receivable and investment, regardless of the method of measurement and/or classification. Without this total overview, reconciliation with the statement of financial position is often difficult or impossible. This is partly due to the fact that IFRS does not require disclosure of the maximum credit risk of accounts receivable and investments that are measured at fair value. Strict application of IFRS does not improve clarity, and it is questionable whether the general objective stated in IFRS 7 is met. This does occur if accounts receivable and investments that are measured in different ways and recognised in one item in the statement of financial position are shown in a total overview.

Furthermore, it is not always clear which disclosure shows the maximum exposure to credit risk, since several disclosures are included that appear to be similar.

The purpose of disclosures of credit quality and concentration risk is not always clear

The information provided on the credit quality of the net exposure varies. For outstanding accounts receivable from customers, banks usually provide overviews on the basis of internal weights and ratings and on the basis of the Basel II approach. These disclosures, both of which are useful, do not always reconcile either with each other or with the statement of financial position in some cases. The reason for giving two disclosures is also not always clear.

In general, attention is devoted (either explicitly or otherwise) to concentration in the portfolio. This is important, because the degree of concentration per sector or nature of activities provides information on the risks that these companies are exposed to. Here too, the degree of detail provided varies. A qualitative disclosure is not always supported by quantitative data. It is also not always clear whether the disclosure (for instance, accounts receivable per sector or geography) is intended as a disclosure of credit quality or a disclosure of concentration risk.

Some banks link concentration risk in lending to a single customer, while the disclosure provided by others focuses on one sector or portfolio. A number of banks also provide a qualitative disclosure, for example in relation to specific products and

\[2\] Ratings for prudential purposes
portfolios for which a particular risk is recognised and of the approach taken to deal with this.

For a proper understanding of concentration risk, it is not always sufficient to include a classification per sector and geographical region. It is indeed the combination of these two overviews, for instance in matrix form, that makes it possible to understand the nature of the concentration risk. It is also important that companies provide further information with respect to these overviews.

Insurers provide information on the credit quality of their investments by disclosing the rating, in some cases grouped by geographical region, type of debtor and type of loan. Here too, it is not always clear whether the disclosure relates to quality or to concentration.

The AFM notes that it is important to consider (or reconsider) which disclosures (relating to quality and/or concentration) require additional attention each year. In 2010 and 2011, there was much interest in exposure to peripheral eurozone countries. Many banks and insurers have since reduced their positions in these countries. The AFM sees that the disclosures of these positions are still extensive, although they are perhaps less relevant at this time. Disclosures of other important matters on the other hand could, as part of the disclosure of concentration risk, have become more relevant. Banks and insurers need to be continually aware of this point.

Nearly half of the banks provide no disclosure of collateral per category and the measurement thereof

Only four out of seven banks provide a list stating the account receivable or investment and the nature and size of the collateral for each category. The disclosure of the method used to measure the collateral ranges from concisely to highly-detailed. If collateral leads to a material mitigation of risk, the AFM expects to see a detailed disclosure. This should explain the nature of the collateral, the way in which the value of the collateral is established and the degree to which there is a situation of ‘overcollateralisation’ (the value of the collateral is greater than the amount of the outstanding account receivable) per category of account receivable.

Apart from derivatives, the disclosure of collateral by insurers is less material and is less extensive than that provided by the banks.

The disclosure of payments in arrears by banks could be clearer, and by insurers more detailed

Payments in arrears at banks are rising due to the economic conditions. The disclosure of this varies. All the banks include an overview of payments in arrears on accounts receivable for which no provision has been formed. This does not include all
types of receivable in all cases. The relationship with other overviews is moreover not clear in all cases.

Only two out of six insurers provide information on payments in arrears for the debt instruments recognised as financial non-current assets ‘available for sale’. These debt instruments represent a large part of the portfolio. The AFM sees room for further improvement here.

3.1.2 Banks provide too little information on restructured loans (forbearance)
In the current economic conditions, all banks are seeing an increase in the provision for loans provided. Banks must disclose the measures used to manage impairments and they must provide information on their analysis of the age of outstanding items. Given the market conditions, investors value a qualitative and quantitative disclosure with respect to restructured loans (forbearance). This concerns the measures used, how the effects are recognised in the financial statements and the financial impact. Only one bank provides quantitative information on forbearance, although all the banks disclose that they have restructured loans. Improvement is required here.

Nearly all the banks provide a qualitative disclosure of the terms and methods they use in the identification of impairments. This is also required under IFRS. Three of the seven banks provide a further analysis of portfolios for which individual or collective provisions have been formed. IFRS requires only an analysis of the individual items for which a provision has been formed, however the AFM notes that an analysis of items for which both individual and collective provisions have been formed can be useful for an evaluation of the loan portfolio.

3.1.3 The disclosure by banks/insurers of ‘assets held for sale’ could provide more information regarding the risks of impairment
Changes in the value of financial assets held for sale are in the first instance recognised in equity. A positive or negative revaluation reserve is thus created. The income statement is only affected if there is a sale or an impairment.

Although very few impairments were recognised in the 2012 financial year, the disclosure regarding the revaluation reserve could be improved, as stated below.

Disclosures providing information on the risk of a future impairment are either not included or very limited. A further analysis of investments with a negative revaluation reserve is therefore usually missing. The AFM advises companies to include a breakdown of their negative reserves by sector and/or country. A disclosure of the reason why an impairment is recognised or not in the case of negative reserves is also relevant information.
One insurer provides an overview of the negative revaluation reserve per type of asset in the financial statements and discloses the assessment made with respect to potential impairments.

This disclosure is mainly important for insurers. The portfolios of assets available for sale at banks are generally not so large.

3.2 Trading and industrial companies
In view of the current economic circumstances, the AFM expected trading and industrial companies, especially those in cyclical sectors, to pay specific attention to credit quality and concentration risk. We see this only to an insufficient extent. The AFM does not see great changes in the level of the provisions in relation to the outstanding accounts receivable. Given the economic conditions, companies could have provided a disclosure of this.

3.2.1 Better disclosure needed of contracts for third parties
It is notable that the assessment of the maximum credit risk by companies performing contracts for third parties sometimes includes the balance not yet invoiced and sometimes does not. This balance of ‘contracts for third parties’ occurs for instance with construction companies and other technical service providers, engineering companies and software developers. This involves credit risk to some extent. It can be important to include this item in the disclosure of credit risk.

3.2.2 Disclosure of credit quality and concentration risk can improve
Half of the companies state that they are not exposed to concentration risk. Moreover, many companies do not provide any information on concentration risk. Companies that do provide information state the share of their largest customer or the geographical diversification. The AFM would have expected to see a disclosure of concentration risk by more companies, given the nature of the companies included in the review. In this context, the disclosure of credit quality can also be improved. Only a minority of the companies reviewed provide a disclosure of credit quality.

3.3 Other - banks provide little or no information on the assets that have not (or not yet) been provided as specific collateral
In its review of the reporting of credit risks, the AFM has also considered the disclosure by banks of assets that have not yet been placed by them as collateral. Although these do not directly relate to credit risk, the AFM considers it important that its findings should be included in this reporting.

In the evaluation of credit quality, it is also important that investors understand the assets available for use as collateral and the quality of these assets. The evaluation of credit quality can be influenced by the quality and size of the assets that have been provided as collateral.
Banks often provide information on securitisations and the extent to which assets from this are still available as collateral. This disclosure is not clear in all cases, for example regarding the remaining availability of parts of the securitisation that are retained within the group.

The structure of the disclosure of the assets placed as collateral can be improved. Sometimes the disclosure in question is provided in the disclosure of the item in the statement of financial position, and sometimes an overview of pledged assets is provided as a separate disclosure. It is also the case the disclosures are provided at different points for various types of activity. Further information on the nature of the pledged assets and the conditions of the pledge is not provided in all cases. The relationship with the liabilities with which the placement of collateral is associated is not explained, or only to a very limited extent. This makes it difficult to obtain a total picture of the pledged assets, the funding structure and the availability of assets for all creditors.

Furthermore, none of the banks provided a total overview of the assets still available as collateral. In one case, the bank in question stated that it would disclose this in future. The AFM wishes to note that a total overview of already pledged assets does not necessarily provide information on which assets are still available for use as collateral, for instance in order to raise liquidity. It is therefore important that the banks provide a statement of assets still available for use as collateral.

Apart from derivatives, the disclosure of assets placed as collateral by insurers is less material and is less extensive than that provided by the banks.
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