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Missing Requirements on Disclosure Discipline Concerning Liquidity

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Abstract Accounting standards can have a significant impact on the liquidity of an entity: both management decisions and the control exercised by supervisory Authorities are influenced by accounting information. Nevertheless the objective of the IASB is to provide users of financial statements with "relevant and useful information […] for their assessment of the amounts, timing and uncertainty of the entity's future cash flows", there are some critical points associated with those requirements, in particular for the banking sector. Indeed, it lacks to define the concept of liquidity and to pay attention to the economic maturity of certain items, which is important as well as their amounts. Moreover, given that the information contained in the statement of financial position and the statement of cash flows serves some limitations for the assessment of the liquidity profile of an entity, it is expected that these gaps are filled by the disclosure. Nevertheless, even IFRS 7 presents some deficiencies that will be underlined in this paper. It is believed that current requirements could be profitably complemented.

Keywords Liquidity, Risk, Disclosure, Maturity, Cash Flow, Value, IASB, Bank

1. Introduction

Disclosure is useful in order to provide information to different stakeholders, so that they can satisfy their information needs according to decisions they will assume. As is known, a distinction can be drawn between financial and economic decisions on one side and stewardship assessments on the other side [15]. In the former case, information is used in order to assume valuation decisions and, typically, a future-oriented or forward-looking information is required (so, an ex-ante role). In the latter, it is used to monitor the management's use of capital after its investment in the entity (an ex-post role of information). As evidenced in the literature, the two roles are not always aligned[22]. In the case of information concerning the management of liquidity risk, both of them could be useful, even if the valuation role seems of primary importance assuming that it is necessary to evaluate either the company's potential risks and rewards or its future expected outcomes[5]. It is important to note that disclosure should not be intended as a substitute for recognition and measurement but as a complement to them[5]. In particular, concerning the liquidity risk, it should provide all the information useful to assess the liquidity profile of assets and liabilities (if it is not possible to reach such a knowledge only by the reading of the statement of financial position), the timing and amounts of future cash inflows and outflows -deriving form recognized and unrecognized items- and all other elements concerning internal metrics, if so, used to manage this kind of risk ([1]).

Next sections will be devoted to depict concepts of liquidity and liquidity risk, the importance of disclosure for their assessment and actual requirements of IFRS 7, stressing its critical points and deficiencies. Finally, a discussion and some conclusions will be presented.

2. Liquidity and Liquidity Risk

Liquidity is not an easy notion to define and does not have a univocal meaning: both a stock dimension, interpreted as the availability of cash or equivalents, as well as a dynamic one can be referred to. According to the latter "Liquidity represents the capacity to fulfil all payment obligations as and when they fall due – to their full extent and in the

1 It is important to note that previous studies tested the impact of an increase in transparency and quality of reporting on liquidity risk and on liquidity measures. See, for an example: Sadka R., Liquidity Risk and Accounting Information, Journal of Accounting and Economics, 52, 2011, pp. 144-152; Daske H., Bischof J., Mandatory Disclosure, Voluntary Disclosure, and Stock Market Liquidity: Evidence from the EU Bank Stress Test, Journal of Accounting Research, Vol. 51, Issue 5, December 2013, pp. 997-1029; Frino A., Palumbo R., Capalbo F., Gerace D., Mollica V., Information Disclosure and Stock Liquidity: Evidence from Borsa Italiana, Abacus, Vol. 49, Issue 4, December 2013, pp. 423-440; Pagano M., Volpin P., Securitization, Transparency and Liquidity, Review of Financial Studies, Vol. 25, Issue 8, August 2012, pp. 2417-2453; Lang M., Lins K. V:, Maffett M., Transparency, Liquidity and Valuation: International Evidence on When Transparency Matter Most, Journal of Accounting Research, Vol. 50, Issue 3, June 2012, pp. 729-774.

currency required. Since it is done in cash, liquidity relates to flows of cash only.[10]". Or, in a broader way, the concept may also embrace the company growth process, that is the ability to fund new business transactions; in this case "Liquidity can be viewed as the essential resource that permits a company to replace its liabilities, meet contractual obligations, and fund growth, all at reasonable price, as and where needed [2]".

Moreover, liquidity is positively related to financial flexibility: a more liquid entity is more likely to have a superior ability to adapt to unexpected needs and opportunities, as well as a lower risk of failure.

As a complex item[25], liquidity can be investigated through its components [2]:

1) funding liquidity: liabilities (both short and long term) from which cash can be drawn;
2) asset liquidity: availability of assets which can be sold or pledged in order to obtain cash;
3) liquidity contingencies: future events that can impact on cash flows.

In theory, if a firm owns assets and liabilities well matched (in terms of duration) and if it can hold them until their maturity, assuming the absence of new transactions, it faces no liquidity risk: at these conditions, maturing assets will provide the funds needed to repay liabilities as they come due. Such a model, however, is just an ideal and static (it is true only neglecting liquidity contingencies and impacts of future scenarios) one. Entities, especially financial institutions that operate the maturity transformation, cannot satisfy the above-mentioned conditions; moreover, they serve the accounting estimates and must deal with unexpected events.

As a consequence, liquidity risk is an exposure that every firm must consider and manage.

To this end, it is useful to clarify that liquidity risk consists of many components[2]:

1) asset liquidity risk: coming from the inability to convert assets into cash at the expected value;
2) funding liquidity risk: arising from an inability to access unsecured funding sources at an economically reasonable cost in order to meet obligations;
3) liquidity mismatches risk: arises when maturities of assets and liabilities do not match, leading to divergent cash inflows and outflows over time and consequential losses;
4) liquidity contingencies risk: refers to losses resulting from unexpected future events that may absorb liquidity flows.

Some of them are influenced by accounting rules, in terms of recognition, measurement and disclosure.

In particular, the asset liquidity risk is the most influenced by accounting rules: values assigned to assets should be predictive of their potential cash flows, while disclosure should provide useful information to investigate their timing.

Connections between the funding liquidity risk and accounting rules depend on how the former is interpreted. If it is considered as previously defined (inability to access unsecured funding sources at economically reasonable costs in order to meet obligations), accounting rules do not exert a direct influence on it. On the other hand, if it is understood as the possibility that the entity will become unable to settle obligations with immediacy, amounts (measurement rules) attributed to liabilities become important, as well as their timing (disclosure rules).

Regarding the liquidity mismatches risk, as financial instruments could be managed on a portfolio view, it is desirable that accounting rules take into account the specific business model adopted.

Finally, financial reporting should provide evidence of liquidity contingencies risk, if not through recognition, when there are no conditions for admittance of future/potential events in financial statements, at least by adequate disclosure.

Hence, the next section will be devoted to investigate to what extent IASB accounting rules on disclosure capture these connections.

3. IFRS 7: Requirements and Deficiencies

In the case of information concerning the management of liquidity risk, both the stewardship assessment and the valuation role of information could be useful, even if the latter seems more relevant, assuming that "without clear and complete disclosure of a company's risk exposures, its plans and strategies for bearing or mitigating those risks, and the effectiveness of its risk management strategies, investors will be unable to evaluate either the company's potential risks and rewards or its future expected outcomes"[5].

According to ESMA[16], entities could enhance their liquidity risk disclosure, complementing quantitative data with narrative information and explaining the latter with quantitative elements. Indeed, the overall quality of disclosure could be improved by providing definition of key terms, inputs and assumptions for indicators used to assess liquidity and funding positions; narrative commentary on contractual maturity; analysis of financial assets and liabilities other than figures and connections with the entity's strategy and objectives in terms of funding and liquidity.

EFRAG [14] suggests a few issues, necessary for a better portrait of liquidity risk, including the following:

1) whether assets can be easily sold or refinanced in order to raise funds (asset liquidity);
2) stability and diversification of sources of funding, including regular and potential sources resulting from the occasional sale or refinancing of assets (funding liquidity); and
3) stress analysis, including testing whether liquidity buffers would be sufficient to face the occurrence of a stress scenario (liquidity contingencies).

In summary, disclosure concerning liquidity risk should provide information useful to assess the liquidity profile of assets and liabilities (when such information cannot be achieved through the balance sheet), the timing and amounts of future cash inflows and outflows - deriving form recognized and unrecognized items - and all other elements concerning internal metrics, if so, used to manage this kind of risk ([2]).

Banks liable to IAS/IFRS shall adopt IFRS 7 Financial Instruments: Disclosures[20]. The importance of this Standard is underlined into the introduction, where it is clarified that: "The IASB believes that users of financial statements need information about an entity's exposure to risks and how those risks are managed. Such information can influence a user's assessment of the financial position and financial performance of an entity or of the amount, timing and uncertainty of its future cash flows" [20].

In order to deepen main critical points associated to IFRS 7's requirements concerning liquidity risk disclosure,, it should be answered to three main questions:

1) *What* should be disclosed?
2) *How* should it be disclosed?
3) *When* is it necessary to disclose information derived from the first two points?

The first question is related to elements to disclose. Information should encompass, among other aspects, those concerning:

1) Values of assets and liabilities.

Carrying value could diverge from liquidity value, because of the valuation method (cost vs fair value), the perspective adopted into the valuation process (entity vs market participant) and asset liquidation costs. The latters could derive from the liquidation time horizon, the asset type (standardized or not) other than its fungibility and the market structure [8]. In case of differences (between carrying and liquidity values), deriving from haircuts or appreciations in liquidity value as compared to the carrying amount, a table of reconciliation and an explanation of causes of differences could be useful to complement actual IFRS 7's requirements, just focused on changes in the fair value attributable to alterations in the credit risk ([3]) of financial instruments. Indeed, according to Recommendation 18 of the EDTF (*Enhanced Disclosure Task Force*) of the FSB (Financial Stability Board), it would be useful to "describe how the bank manages its potential liquidity needs and provide a quantitative analysis of the components of the liquidity reserve held to meet these needs, ideally by providing averages as well as period-end balances. The description should be complemented by an explanation of possible limitations on the use of the liquidity reserve maintained in any material subsidiary or currency"[19].

Another element to show could be the amount and the composition of liquidity reserves and of stock of assets available for liquidity purposes or to meet funding needs, free of regulatory, legal or contractual charges and that could be used as collateral or pledged to secure liabilities (i.e. unencumbered assets). Indeed, Recommendation 19 of the EDTF of the FSB prescribes to summarise encumbered and unencumbered assets in a tabular format by balance sheet categories, including collateral received that can be rehypothecated or otherwise redeployed. This is to facilitate an understanding of available and unrestricted assets to support potential funding and collateral needs[19]. A clear and internationally accepted definition of asset encumbrance is still missing, as well as elements that should be included in the category and their values, but the European Banking Authority (EBA) is currently developing harmonised guidelines of it for supervisory reporting [11, 12]. Concerning this point, IFRS 7 requires to disclose only fair values of collaterals and financial assets pledged to secure liabilities, but does not give many references concerning the amount of liquidity reserves detained for liquidity management, except than deposits at Central Banks [20], as well as criteria used to identify the so called *high quality liquid assets* [3].

2) Maturities of assets and liabilities and timing of cash inflows and outflows.

Disclosure concerning the management of liquidity risk should consider also amount and timing of future cash inflows and outflows, that is maturity of assets and liabilities. To this extent, it is useful to divide flows in time buckets (or bands, as defined in IFRS 7). Cash movements can be classified according to the contractual and/or expected maturity of on and off balance sheet items, depending on the estimated time of settlement, sale or transfer of them. The consideration of contingencies, commitments and unrecognized items, such as intangibles, could be useful in order to properly depict the liquidity situation of the entity. Buckets could be built using different assumptions, both in a normal and in a stress period (scenario analysis). Moreover, in each bucket, an useful figure to be disclosed is the difference between assets giving origin to cash inflows and liabilities giving origin to cash outflows, in order to assess the net cash outflow for the specific period of time, that is the "*cumulative funding gap*", useful to assess maturity mismatches.

Cash flows can be ascertained even using the entity's maturity estimates for certain balance sheet items. This is especially valid for demand or non-maturity deposits, loans with pre-payment options and structured notes. In this case, disclosure should explain assumptions used in the assessment of behavioural liquidity characteristics where these differ materially from the contractual maturity. Indeed, Recommendation 20 of the EDTF of the FSB prescribes that "*Banks should provide a narrative discussion of management's approach to determining the behavioural characteristics of financial assets and liabilities*" [19]. Concerning this point, IFRS 7 states that an entity shall

2 For an analysis of risk disclosure practices, see: Aureli S., Salvatori F., Investigation of Risk Management and Risk Disclosure Practices of Italian Listed Local Utilities, Financial Reporting, 2013(1); Buzzichelli F., Di Pietra R., Risk Profile Disclosure Requirements for Italian Insurance Companies: Differences in the Financial Statement Preparation, Financial Reporting, 2013(1).

3 It is possible to underline an alignment with provisions of IFRS 9 (IASB, 2010), which does not consider the *liquidity risk premium*.

disclose a maturity analysis for financial liabilities, derivative financial liabilities and financial assets (the latter only if it enables users to evaluate nature and extent of liquidity risk), assessing an appropriate number of time bands. Cash flows for each category and band are based on contractual maturities, with no reference at expected or behavioural liquidity characteristics of on and off-balance sheet items. For example, in the case of demand deposits and, more generally, for all items to which are connected a range of possible maturities, cash flows are included on the basis of the earliest date on which the entity can be required or is permitted to pay[20]. Definitively, the standard appears quite poor relative to these issues, as it does not consider timing and economic maturity (quite typical for financial institutions) of certain items and cash flows associated to unrecognized items.

The second question is related to the presentation of information previously identified. While IFRS 7 requires to divide qualitative and quantitative information and to illustrate significant concentrations of liquidity risk, in asset liquidity or funding liquidity [20], an addition of tables and their explanations could be a useful complement. Moreover, information about values and maturities could be disaggregated according to different currencies, geographical areas, markets, counterparties and business lines, in order to assess the concentration of the Liquidity Risk in each identified segment[6].

The third question is connected to the timing of disclosure. It is important to highlight that liquidity (and liquidity risk) is not a static concept [13]. It could change over time depending on macroeconomic and market conditions, other than entity changes. So, disclosure provided in financial statements may not be enough for investors to ascertain the liquidity risk of an entity. It could be the case to periodically integrate it by the use of some other documents, such as Risk Reports, Operating and Financial Reviews, Management Commentaries ([4]) etc. In each case it is important to use cross-references among different instruments used to disclose information about the liquidity risk management.

4. Conclusions

The objective of this study has been to evaluate if the disclosure provided by entities through the financial reporting correctly reflects their liquidity risk exposure. Indeed, nevertheless liquidity is an important issue to be dealt with, it has not been fully addressed in accounting standards.

Actually, the latters should give information useful to predict future cash flows, their amounts and timing. To this end, it would be necessary that the IASB first define the concept of liquidity and then mark accounting principles in line with it.

One of the main weak points of the discipline is the lack of a framework (in terms of liquidity concept) within which systematically build recognition, classification, measurement and disclosure recommendations.

Especially concerning disclosure references, it is possible to identify some deficiencies, as IFRS 7 does not require adequate information about differences, if so, between the carrying value and the liquidity value (depending on the liquidation time horizon, the asset type other than its fungibility and the market structure) and about the economic maturity. Concerning the latter point, indeed, it is known that cash flows can be ascertained even using the entity's maturity estimates for certain balance sheet items. But, according to IFRS 7, cash flows for each category of assets and liabilities and for each band are based on contractual maturities, with no reference at expected or behavioural liquidity characteristics for on and off-balance sheet items.

Concerning the presentation of information, an addition of tables and explanations of them could be a useful complement. In particular, disclosure provided in financial statements could be periodically integrate by the use of some other documents, as liquidity is not a static concept and may change very fast. In each case it is important to use cross-references among different instruments used to disclose information about the liquidity risk management and remember that, according to the materiality concept, entities shall not aggregate or disaggregate information in a manner that obscures useful elements for stakeholders.

In a nutshell, it is believed that current requirements could be profitably complemented by international Authorities and, in particular, by the IASB, that could even consider the possibility to issue a standard specific for the banking sector.

In order to provide more concrete suggestions, this research will be integrated by deepening aspects related to Basel III provisions concerning the *Liquidity Coverage Ratio* (LCR) and the *Net Stable Funding Ratio* (NSFR) disclosure standards. Moreover, it will represent a starting point for an empirical research to be conducted in next years, as the process of implementation of Basel's requirements will be carried out in a long period. Information about the behaviour of a sample of banking groups will be collected, in order to test their accounting choices for liquidity reporting in a spatial and in a temporal context.

4 For an example related to liquidity disclosures in the MD&A, see: Cole C. J., Corporate Liquidity Disclosures: A Review, The Journal of Corporate Accounting & Finance, November/December 2012, pp. 65-77.

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