A F E P

Association Française des Entreprises Privées

IASB
30 Cannon Street
London EC4M 6XH
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Paris, September 11, 2009

Re: *Replacement for IAS 39 – phase 1 – Classification and measurement*

We welcome the opportunity to comment on the IASB exposure draft dealing with classification and measurement of financial instruments.

In our response to the IASB DP "Reducing complexity" we had stated the following on classification and measurement:

"We note that there are basically two measurement attributes for financial instruments, amortised cost and fair value[1], and we believe that these two measurement attributes are needed to ensure that financial assets and liabilities are accounted for in a relevant manner. Indeed we believe that market variations should be reflected in the measurement of assets and liabilities only to the extent that market variations have an impact on the cash outcome of the instrument. Instruments which are due to be settled in conformity with their contractual features (interest rate for debt instruments for example) are best measured in accordance with contract inputs (which are characteristics of the instrument, not of the entity), i.e. at amortised cost, if financial statements are deemed to have predictive value… ... In addition we do not believe that a standard on financial instruments can valuably ignore how financial instruments are managed… We support the revision of IAS 39 in view of setting clear principle based and durable requirements…."

[1] Throughout this comment letter, we refer to "fair value". However please refer to our comment letter on fair value measurement where we suggest that "fair value" may not be the most relevant market-based measurement attribute for financial reporting.

We are therefore particularly pleased with the direction that the Board is taking. We agree with the basic principle that financial instruments that have "basic loan features" and are managed "on a contractual yield basis" are measured at amortised cost, the others being measured at fair value. We acknowledge though that few exceptions to this principle need to be decided, in order to avoid accounting mismatches (fair value option), when markets are inactive (liquidity factors become irrelevant) and when fair value would be based on level 3 estimates (no outstanding gain should be recognised on the basis of level 3 estimates).

However we believe that the business model of the entity should come as a more prominent criterion in the analysis. Combining measurement and presentation requirements should lead to limit financial instruments measured at fair value with changes in fair value presented in P/L to those that are managed on a fair value basis. Moreover we observe that some decisions made by the Board contradict the proposed basic principle and would, if not reversed, eliminate the benefits from identifying and setting a robust principle: adopting a principle-based approach would call for a principle-based definition of "basic loan features", require embedded derivatives in host contracts that qualify as basic loan and are managed on a contractual yield basis (i.e. performance is reviewed by senior management on the basis of amortised cost data) be bifurcated; waterfall structures should not disqualify any tranche to be assessed as having basic loan features if indeed those characteristics remain present; in those rare circumstances when market changes would trigger a change in business model or generate more variations than the fair value option would compensate, reclassification should be required, from one category to the other and out of the fair value option. Short of these decisions to be reconsidered, the final amendments would restrict the population of instruments carried at cost dramatically, away from the business model of the entity, and contradict the IASB announcement that the revision meant less instruments measured at fair value. In addition, the new standard would not be based on a robust principle.

Beyond this main comment, we are formulating the following views:

- We believe that the reliability recognition criterion in the framework calls for the cost exemption for unquoted equities to remain; furthermore, we believe that a lesson learned from the crisis calls for fair value to be replaced by a measurement based on lower of cost or fair value when fair value relies on level 3 estimates;

- We agree that changes in value of equity investments be presented differently, depending on whether the equity investments are managed on a fair value basis, or not; existing presentation requirements for equity investments not held for trading should in our view be maintained (dividends in p/l, changes in value in oci, impairment losses in p/l, recycling of gains and losses upon derecognition);

- We agree that the existing impairment requirements need to be revised, and the prohibition to reverse an impairment loss be lifted; we believe that ias 36 impairment model should be considered to that purpose, as it would be based on forward looking information;

- We agree that the "fair value"[2] option be maintained, as an exception to the basic principle, in the sole circumstances in which otherwise an accounting mismatch would arise, since providing useful information to capital providers is paramount. We believe however that disclosures need to be provided, so that users are in a position to fully understand the impact of the entity's business model;

- We agree with the transition provisions proposed. We also agree with the tentative effective date with early application allowed;

- We remain strongly opposed to any change in the entity's own credit risk to be reflected in the measurement of liabilities. If the IASB confirms its view that fair value needs to reflect changes in own credit risk, we would object that fair value be used for any liability and favour instead another current measurement basis (fair value without own credit risk);

- We believe that whenever markets are inactive financial assets and liabilities should no longer be measured at fair value. Inputs that reflect that the market is inactive (liquidity factors) should not influence subsequent measurement; indeed those inputs cannot be deemed relevant to depict the value of financial assets and liabilities.

We wish to address also two non-technical issues in relation to the revision of IAS 39:

- We doubt that dividing the comprehensive review into three steps and allowing early application of different phases in isolation serves the quality and relevance of financial reporting. Our understanding of the EU request was that impairment issues should be resolved before the end of 2009. We do not believe that the IASB has identified and decided a proper response to the EU concern and need;

- We are concerned that the FASB has decided to go a divergent route. We believe the IASB should do its utmost in order to convince the FASB to adopt the same overarching principle as the IASB and help the IASB to solve the shortcomings in its proposal towards a joint principle-based standard.

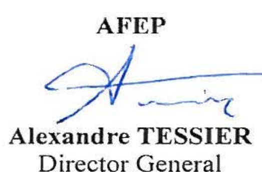
In addition to these main comments, answers to the detailed questions of the invitation for comment are provided in the appendix.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

ACTEO

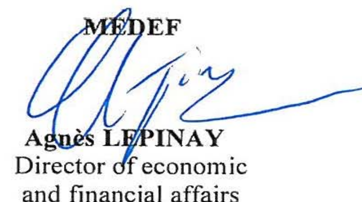
Patrice MARTEAU
Chairman

AFEP



Alexandre TESSIER
Director General

MEDEF



Agnès LEPINAY
Director of economic and financial affairs

[2] See comment on own credit risk

Appendix to our letter on IASB Exposure Draft on Classification and Measurement of financial instruments

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

Yes, we agree that amortised cost provides decision-useful information for a financial asset or financial liability that has basic loan features[3] and is managed on a contractual yield basis. In our letter commenting the DP "Reducing complexity in the accounting for financial instruments" we had recommended the IASB set such a principle. We are therefore pleased that the IASB proposes this principle in its ED. We believe that such measurement is superior to a measurement at fair value, as it better portrays the future expected cash flows that instruments having basic loan features and managed on a contractual yield basis will generate.

We note that the IASB does not question the relevance of fair value for all financial instruments that do not qualify as having basic loan features. While an exposure-draft on fair value measurement has recently been published, the IASB has launched an open consultation to discuss whether own-credit risk, and more generally non-performance risk, should be part of the valuation of liabilities. Were the IASB to confirm their decision that fair value incorporates non-performance risk, we would strongly oppose to financial liabilities (including quoted debt instruments) – or any other liability – to be measured at fair value.

Moreover, we believe that a lesson learned from the crisis would call for no longer reflecting any outstanding gains arising from level 3 fair value measurements. The IASB should specify a different measurement attribute to that purpose.

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has "basic loan features" and "is managed on a contractual basis"? If not, why? What additional guidance do you propose and why?

(a) Basic loan features

Guidance provided in the exposure draft of whether an instrument has "basic loan features" is in our view far too restrictive to support the application of a robust principle and ensure that amortised cost is being used in all circumstances where it is more relevant than fair value, i.e. circumstances in which it better depicts expected future cash flows.

[3] We believe that "basic loan features" definition is too restrictive. Our agreement is subject to our answer to question 2 being satisfied.

We agree that the notion of "basic loan features" should encompass contractual terms that give rise to cash flows that are payments of principal and interest on the principal outstanding and that are subject to credit risk. However we disagree that contingent changes in the timing and amount of payments of principal and interest on the principal outstanding be excluded of the definition. We cannot see why a contingent variability of principal or interest rate or timing of cash flows would disqualify the instrument from being accounted for at amortised cost, if the conditions that principal be repaid in full and interest be served are met. The interest to be served on a loan can, for example, vary depending on the performance of the entity. We observe that in its DP on Leases, the Board has analogised liabilities arising from leases with borrowings and asked that contingencies be reflected in the valuation without requiring fair value. All it takes is the ability to estimate the amount and timing of cash flows. Reverting to the market interest rate or including a liquidity risk factor in the valuation of the instrument at fair value would not provide a better estimate of future cash flows to or from the entity, if the instrument is being managed on a "contractual yield basis". Similarly we do not see any logical reasoning why tranches in securitisations other than senior tranches would be excluded from the definition of basic loan features, if the issuer remains compelled to pay principal and interest (that incorporates a higher risk premium), and if cash flows to be received are subject to a reliably measurable credit risk.

(b) Managed on a contractual yield basis

We agree with the guidance provided in AG9 – AG13, except that we disagree that loans that are purchased at a discount to reflect incurred credit losses would be necessarily denied to be managed on a contractual yield basis. As indicated by the Board in BC32, "an entity's business model… …is a matter of fact that can be observed". The logical consequence is that no standard can define in abstracto and a priori facts that are to be observed in practice. Loans purchased at a discount are not necessarily held for trading.

As indicated in our cover letter, we believe that the business model criterion should be more prominent in the analysis. In the model presented by the Board, the business model plays a role in defining accounting requirements only when "basic loan instruments" are considered. We believe that the business model should play a role for all circumstances. Measurement is not the only means available to reflect the business model of the entity. Presentation of gains and losses in the income statement and comprehensive income statement should also play a role.

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

(a) What alternative conditions would you propose? Why are those conditions more appropriate?

(b) If additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets and liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?

(c) If financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

We have indicated our support for the high level principle that the IASB is proposing. As explained in our answer to questions 2 and 4 (a) and (b), we believe however that the proposed principle should be applied without any restriction to ALL instruments that meet the proposed characteristics. Unless that is the case, the new IFRS would not make it easier for users to understand the information about financial instruments as described in BC 15. Therefore we believe that more instruments should be carried at amortised cost than the IASB is proposing. Indeed:

- some instruments that AG1 to AG8 would exclude should be accounted for at amortised cost (our response to questions 2 and 4 (b));
- host contracts that have "(revised) basic loan features" and are managed on a "contractual yield basis" should be measured at amortised cost (our response to question 4 (a);
- unquoted equity instruments should be valued at cost if and when no fair value can be reliably measured.

In addition there should be limitations to the use of fair value in the following circumstances :

- whenever markets are inactive, measurement of financial assets and liabilities should not reflect current liquidity inputs. Those current liquidity inputs are no more relevant than the isolated transaction prices that can be observed;
- no outstanding gain should be recognised if it relies on level 3 fair value estimates.

Question 4

(a) Do you agree that the embedded requirements for a hybrid contract with a financial host should be eliminated? If, not please describe any alternative proposal, explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

No, we do not agree with the elimination of the bifurcation of embedded derivatives in financial hosts. We believe such elimination violates the proposed classification principle and, as a result, undermines significantly the benefits that are expected from the application of that principle. As explained in our answer to question 1, we believe that amortised cost best reflects future cash flows that are expected to arise from instruments having basic loan features and managed on a contractual yield basis.

We believe that out of the three alternatives the Board considered, the Board should have adopted to retain the requirements in IAS39 (BC44-a), while addressing and solving as well as possible difficulties identified in practice.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you proposed for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

No, we do not agree with the proposed application of the proposed classification to contractually subordinated interests. Nor do we agree that loans purchased at a discount should be measured at fair value in all circumstances. Our reasons are detailed below:

- There is little economic difference between subordinations that result from legal requirements and those that arise from contractual provisions;

- Most tranches in securitisations other than senior tranches do provide the holder with rights to perceive payments of principal and interest that remain subject to reliably measurable credit risk; the supplementary cash flows that the holder perceives, so to speak "to provide credit protection to other tranches", are no more, no less than the interest paid in compensation for bearing higher credit risk (we disagree with bc27-28); we agree nevertheless that tranches that give their holder only a residual interest, or circumstances in which underlying assets cannot be identified and/or credit risk measured reliably should deny the instrument having basic loan features;

- Loans purchased at a discount are still likely to involve payments of principal and interest, the difference between the purchase price and the fair value being in no way different in economic substance from an upfront fee (we disagree with bc29).

  That being said, we agree with the statement in BC30 where the Board notes that the approach would call for the exercise of judgement. We believe that the final standard will be all the more robust, and uncertainty in practice quite reduced, if judgement is to be exercised in the context of a principle-based guidance, and not on a detailed set of rules depicting when and where instruments are having basic loan features (please refer to our response to question 2). New forms of basic loan features may arise as well, and the standard should not deny them from being accounted for at amortised cost (same reasoning as the Board's in BC18).

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Yes, we agree that the "fair value option" be allowed in order to eliminate or significantly reduce an accounting mismatch, because many business models call for asset/liability management and accounting requirements should not obscure the economics of such activities in calling for inconsistent reflections of the same economic phenomena.

Moreover it is key that accounting mismatches be avoided, not only from a balance sheet perspective, but also from an income statement perspective, i.e. ensure that all changes in value of assets and liabilities that arise from asset/liability management be all in P/L (if relevant) or all in OCI.

That being said, we believe that:

- The Board should do its utmost in order to eliminate possible sources of accounting mismatches;

- The fair value option has the drawback of creating irrelevant changes in value, when accounting mismatches are limited, say for example, changes in interest rate;

- Reclassification out of the fair value option should be allowed if and when market conditions change so dramatically that measurement at fair value generates more discrepancies than it reduces accounting mismatches. While we would agree that such circumstances are rare, the financial crisis has taught us that appropriate requirements in such remote circumstances need to be included in a final standard.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other conditions should it be allowed and why?

No, we do not think that the fair value option should be allowed under other circumstances. The fair value option is an exception to the principle-based approach to classification and measurement that the Board is proposing, and those exceptions should be allowed only if absolutely necessary. We have not identified other circumstances when that would be the case.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications and why?

No, we do not agree that reclassification should be prohibited. Although we agree with the Board that an entity's business model is unlikely to change, and that assets are easily identified as being managed in one line of business or another, circumstances may arise when an entity's activity may be stopped because of, for example, significant changes in market conditions. The experience of the last two years tells us that such circumstances are possible. The decision made by the Board hastily in October 2008 is evidence, we believe, that a standard dealing with classification and measurement of financial instruments has to allow for reclassification. There also, a robust principle-based guidance should not be undermined by arbitrary rules.

Financial reporting requirements upon reclassification defined by the Board in October 2008 are in our view fully appropriate and should be maintained.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

We disagree with the Board's decision to remove the exemption to measure at fair value unquoted equity investments for which fair value cannot be measured reliably. The framework calls for a reliability recognition criterion; changes in value that cannot be measured reliably should therefore not be recognised. Where a reasonable reliability threshold cannot be met, we believe that no information can be relevant to users.

We believe that the Board should maintain the exemption, while clarifying if need be that whenever the fair value of equity investments can be determined reliably, those investments should be measured at fair value.

The Board's basis for conclusions is quite unconvincing, as the Board does no more than to assert that fair value will always be reliably measurable, an assertion that nobody can reasonably sustain. Whenever the assertion verifies, the exemption will not be used and therefore not prevent the accounting requirement that the Board calls for. If that is not the case, the Board's decision would force entities into infringing one of the two fundamental qualitative characteristics of financial reporting, i.e. reliability.

Beyond the above comments, we agree that the general measurement requirement for equity investments be fair value.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

As indicated in our answer to question 8, we believe that the cost exemption for unquoted equity investments that cannot be measured reliably at fair value should be maintained. We believe that this exemption avoids reporting unreliable increases in value of equity investments. We believe that while conditions for reliable measurement of fair value are not met, impairment of equity investments reported at cost should be required on as reasonable a basis as possible. Estimates necessary to perform impairment tests do not need the same level of reliability as those required to measure at fair value:

- estimates are needed only in cases where indicators of impairment exist;

- specific disclosures would help users to understand the uncertainty at stake.

Question 10

Do you believe that presenting fair value changes for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

We welcome the distinction the Board is now introducing between measurement of assets and liabilities on one hand, presentation of changes in value on the other. In our answer to the DP "Reducing complexity" we had stated:

"In our view, IAS 39 is built on two, not four, measurement attributes, i.e. fair value and amortised cost. These two measurement attributes are combined with two different presentations of changes in value in the income statement, some changes in value being recorded in P/L, some others being recorded in OCI with appropriate recycling later on. In order to make the accounting standard for financial instruments more understandable and less complex, the IASB needs:

- *to express when and why amortised cost should be used, and when and why fair value should be applied,*
- *to build a rationale to support having changes in value being recorded directly in P/L, or initially in OCI with later recycling to P/L."*

Unfortunately, the IASB has not yet worked on how to define such a principle. In the absence of such a principle, we would concur with the Board's proposal of leaving the two presentations of changes in value open in the upcoming standard on accounting for financial instruments, provided nonetheless that the choice between the two categories be not left a choice instrument by instrument without cause, but rather the indication given to users of whether the instrument is held for trading or meant as a more durable holding.

However we oppose to the Board's tentative decision to eliminate recycling and command dividends to be reported in OCI if changes in value of the related instruments are presented in OCI. Dividends in our view are distinct from outstanding changes in value because they represent rights to cash flows. They therefore belong to P/L in our view and not OCI. We believe the IASB needs to revise the existing impairment rules for available for sale assets in view of greater consistency in application and convergence with US GAAP, while lifting the prohibition to reverse impairment losses. We believe the IAS 36 impairment model should be considered to that purpose.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in fair value of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) How do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

In our answer to question 2 b), we have stressed that financial instruments should be accounted for, taking into account the purpose to which they are acquired and held. We have indicated also that differentiation may come from either measurement of assets or liabilities, or from disaggregation of gains and losses in the income statement.

We therefore agree that entities may elect to present changes in value of equity instruments either in P/L or in OCI, doing so at inception.

To ensure that measurement and presentation remain consistent with the way financial instruments are managed at all times, reclassification should be required in the rare circumstances when a change in business model would occur, along with explanatory disclosures.

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

We agree with the disclosure requirements proposed that should help users understand the transition from the existing IAS 39 to its replacement. However we disagree that only early adopters should provide this information. We believe it is useful also at the time the new standard becomes mandatory.

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

We agree that restrospective application should be the objective. However transition reliefs may have to be designed (similar to the reliefs existing for first-time adopters of the existing standard). The Board should take into account also the possible evolutions in impairment and hedge accounting, prior to finalising the transition provisions.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

(a) In the statement of financial position?

(b) In the statement of comprehensive income?

If so, why?

No, we do not, for the reasons developed in our response to the DP "Reducing complexity" and shortly referred to in our support to the direction proposed by the Board.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than measuring those financial instruments at amortised cost? If so, why?

No, we do not, for the reasons given in answer to question 14.

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