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Paris, 14 Septembre 2009

Le Président

JFL/DC

N°55

IASB
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Re : Exposure Draft "Financial instrument : classification and measurement"

Dear Sir or Madam,

I am writing on behalf of the Conseil National de la Comptabilité (CNC) to express our views on the above-mentioned Exposure Draft.

The IASB issued the first phase of the comprehensive project of the replacement of IAS 39 dealing with classification and measurement of financial assets and liabilities. The CNC highlights the difficulty to comment on the Board's proposals on classification without knowing the changes that will be made to hedge accounting in phase III of the IAS 39 replacement project as well as on other standards interacting with IAS 39, notably IFRS 4 phase II and financial statement presentation. Therefore, opinions expressed in this comment letter are subordinated to the decisions the Board will make on the other abovementioned items.

Moreover, we regret that the timing of the revision of the financial instruments standards by IASB and FASB are not coordinated.

1- The CNC welcomes the following provisions in the IASB's proposals :

- The removal of the tainting rules thus appropriately allowing the use of amortised cost for quoted debt instruments;
- The use of a mixed measurement attribute model, which does allow some debt instruments (quoted or not) to be accounted for at amortized cost ;
- The acknowledgment that the business model cannot be ignored when classifying and measuring financial instruments ;
- The decision to maintain the fair value option.

2- However, the IASB proposals raise fundamental concerns, which are the following :

- The G20 at the London meeting on 2 April 2009 required that the valuation of financial instruments should be based on their liquidity and investors' holding horizons, taking into account valuation uncertainty, and that the complexity of related accounting standards be reduced. However, the IASB proposals focus mainly on reducing complexity and do not deal with the other requirements made by the G20, notably regarding liquidity and investors' holding horizon.
- The IASB does not seem to take into account lessons to be learnt from the financial crisis. On the contrary, the IASB :
  - extends the use of fair value **through profit & loss** since this category would be defined as the default one.
    - Hence, fair value through profit & loss would be extended for equity instruments (notably unquoted equities), some hybrid instruments and some subordinated instruments (notably some instruments that were reclassified from FVTPL to loans & receivables in 2008), even if those instruments are held on a long term basis in accordance with the business model of the holder or if they are illiquid, which raises difficulties in assessing their fair values and leads to unreliable fair value changes being recognised in profit & loss.

      Therefore, by doing this, the Board recreates the same conditions as those raising concerns during the financial crisis.
    - Moreover, even if quoted bonds currently classified as Available For Sale and currently impacting the equity were reclassified into the amortised cost category according to the ED, it would have no effect in principle on the scope of the amortised cost category but a better use of this category by the entities.
  - prohibits any reclassification between categories although this possibility may appear necessary when circumstances force entities to change their business model in response to external changes. Removing the amendment to IAS 39 issued in October 2008 is not an appropriate answer to the G20's concerns regarding the liquidity of financial instruments eligible to the Fair Value through Profit & Loss category. Thus we do not understand how such a removal constitutes a real improvement.

- The limitation of the fair value through other comprehensive income (OCI) to equity instruments and the prohibition of recycling between OCI and profit & loss, which will prevent entities from using this category since it would result in a misrepresentation of their performance in the income statement. As already expressed in previous letters, the CNC strongly believes that **the income statement** (instead of comprehensive income) is the most **relevant indicator of performance**. Moreover, the CNC recommends that the IASB deal with impairment of equity instruments by taking into account investors holding horizons and allow the reversal of impairment.
- The IASB uses the business model overlay in an unbalanced way, i.e. only in order to limit the scope of the amortised cost category whereas the business model should be the main classification criterion for all financial instruments in order to provide through the primary financial statements a decision-useful information consistent with the businesses of the reporting entity.
- The limitation of the amortised cost category to instruments with basic loan features will lead to inadequate information ; the financial instruments with non basic loan features currently recognised at amortised cost should still be eligible to this category if this is consistent with their business model.

3- The CNC considers that classification must be primarily based on the business model (see our classification principles proposals in Appendix III) which leads to the following categories :

a) Amortised cost category : financial instruments that the entity holds (or issued) for the purpose of collecting (settling) contractual cash-flows.

b) Fair value through P&L category : effectively actively traded financial instruments which are held for trading purposes by the entity – such as trading activities in the banking industry - or financial instruments compulsorily held by the entity in order to comply with contractual or regulatory commitments which are required to be settled and measured in the balance sheet (liabilities) at the fair value of these underlying financial assets – such as unit linked contracts in the insurance industry.

c) A third category (for which an appropriate measurement attribute should be determined) : financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or of the fair value through P&L category.

As this last category would not be measured at fair value through P&L, it implies that an impairment model, which should take into account investors' holding horizons, should be determined. Moreover, it should require recognition in profit or loss of impairment on debt instruments relating to credit risk and should allow for reversal (for all instruments) in case of a change in the circumstances leading to impairment.

The fair value option should still be available when it is relevant, notably in case of accounting mismatch at least as long as no visibility is available on the overall IAS 39 replacement project, in particular on hedging proposals, as well as on IFRS 4 phase II.

Moreover, requiring bifurcation of embedded derivatives in hybrids instruments is the best way to represent the nature and cash flows of each component of hybrid instruments.

Finally, reclassification between categories must be required when circumstances prevent entities from continuing to apply their business model.

Such a classification model would achieve an adequate balance between the objective of simplification and the objective of valuing financial instruments based on their liquidity and investor's holding horizons, as required by the G20.

General and detailed comments on the IASB's proposals are provided respectively in the Appendix I and II to this letter. The appendix III presents CNC's classification principles proposals.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Jean-François LEPETIT

Appendix I

General comments

In appendix II we have set our responses to the questions asked. However, because we have found it difficult to express all our views clearly within the confines of those questions, we thought it would be useful to make a few general comments prior to answering to the questions. Such is the purpose of this appendix.

Reducing complexity

The CNC regrets that the IASB focuses only on reducing complexity. As already expressed in the comment letter to the DP Reducing complexity[1], the CNC considers that "accounting for financial instruments is by nature a complicated subject" and that "it remains vital to give priority to the relevance of the accounting treatment".

Moreover, the CNC is not convinced that a final objective to require "a comprehensive fair value measurement for most financial instruments (BC13 and AV2)" will result in reducing complexity since it will transfer complexity on valuation and measurement.

Lessons from the financial crisis

The proposal seems to forget the lessons to be learnt from the global financial crisis. Concerns have been strongly expressed (by the G20, European Commission and FSF for instance) about a wide use of fair value especially through P&L for financial instruments in inactive markets. These concerns led to the issuance in October 2008 of an amendment to IAS 39 on the reclassification of some financial instruments out of categories measured at fair value through P&L. Considering an approach with a wide use of fair value through profit & loss and prohibiting reclassification seems to go in the opposite direction to the one followed in the latest measures taken in 2008 by the IASB in response to the financial crisis.

The proposals do not address requirements expressed by the G20 other than the reduction of complexity. The G20 also asks accounting standard setters to "improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons" and "for valuation uncertainty". The exposure draft on "classification and measurement" does not address these issues. It may be considered that these issues should be dealt with when measurement provisions are discussed. However, the priority given in the exposure draft on "fair value measurement" on market prices or data, does not address the holding horizon's issue and limits the possibilities to consider liquidity and uncertainty elements.

In order to meet the concerns of the G20 on a wide use of fair value, as well as the requirement on liquidity, time horizon and uncertainty, the category at fair value through profit or loss should not be defined by default. On the contrary, financial instruments should comply with a relevant business model to be allowed for inclusion in this category.

[1] CNC's comment letter to DP Reducing Complexity in Reporting Financial Instrument (18 September 2008)

Moreover, it has not been demonstrated that fair value as a measurement attribute for all financial instruments is relevant, especially if recognised in P&L. Subsequent measurement at fair value through profit and loss generates volatility in the income statement which is unhelpful to users of financial statements where the unrealised profits or losses on instruments held for a medium or long term are not ultimately realised. This volatility can amplify the effect of economic cycles and create systemic risk, as illustrated by the recent financial market crisis.

Even when fair value is relevant, the CNC believes that fair value changes related to own credit risk should not be taken into account for financial liabilities (see our comment letter on the DP on credit risk in liability measurement). This concern would get worse if more financial liabilities are at fair value through profit & loss.

Business model

A classification approach for financial instruments cannot be mainly based on the nature of an instrument (basic vs complex). For instance, some may argue that a plain vanilla swap is a basic instrument. We note that there is an agreement among a majority of constituents to recognise all derivatives at fair value. However, some consider that the profile of cash flows of certain derivatives (such as plain vanilla swaps) are very similar to funded instruments with basic loan features, notably because a swap is merely composed of lending and borrowing instruments.

As reminded in a previous letter to FCAG[2], the CNC "is opposed to the principle of measuring all financial instruments at fair value because the fair value measurement attribute is not suitable for all activities. The CNC considers that accounting models should **not ignore business models** and should take into account the way the instruments are managed, in particular when financial assets and liabilities are managed on a cash flow basis".

We note that the proposals introduce the use of a business model overlay only in order to limit the extent of the amortised cost category. Therefore, these proposals appear unbalanced and biased since the business model should better be applied widely to all accounting categories. This implies that the category at fair value through profit or loss should also refer to a business model for which the fair value is the most suitable measurement to provide a useful information to users of financial statements.

For that purpose, the application scope of the fair value through profit or loss category should be improved to include financial instruments that are held under all business models for which fair value is the most appropriate measurement basis. It should compulsorily include held-for-trading financial instruments as currently required by IAS 39, but also financial instruments that must be held by the entity in order to comply with contractual or regulatory commitments towards a third party which are required to be settled and measured on the liability side of the balance sheet at the fair value of these underlying financial instruments. This is the case for financial instruments held by insurance companies issuing unit linked contracts : the insurance company must own the assets in order to back the contractual liabilities linked to the current value of those assets. Under the current IAS 39, these financial assets are classified as "designated as at fair value through profit or loss" (fair value option) because the compulsory classification of financial instruments in the fair value through profit or loss category is limited to the held-for-trading instruments.

[2] CNC's letter to the Financial Crisis Advisory Group's request for input (3 April 2009)

IASB's approach to replacing IAS 39

The Board divided its project to replace IAS 39 into three phases. The CNC wants to highlight the difficulty to comment on the Board's proposal on classification without knowing the final changes that will be made with respect to hedge accounting in phase III of the IAS 39 replacement project.

Therefore, this comment letter expresses our opinion on the exposure draft on classification but is subordinated to the decisions the Board will make on the other elements of the IAS 39 replacement project and also on other standards interacting with IAS 39, notably IFRS 4 phase II and financial statement presentation.

Moreover, we suggest that the Board allows entities to reconsider some of the accounting choices made while implementing these current proposals (for example, the presentation choice for equity instruments or the use of the fair value option), when implementing later phases of the replacement project and standards such as IFRS 4 phase II, since the new way in which insurance liabilities will be measured could imply new mismatches with the accounting treatment of assets (mainly in the scope of IAS 39).

We also regret that the timing of the revision of the financial instruments standards by IASB and FASB are not coordinated.

Appendix II
Detailed comments

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?

The CNC is in favour of measuring at amortised cost financial assets or liabilities held or issued for the purpose of collecting (or settling) contractual cash flows. Amortised cost is the most appropriate measurement attribute for representing the return on these transactions and their cash flows, based on the business model of the entity. When the business model of an entity is not based on the short term trading of financial instruments but on the creation of long term cash flows, measurement at amortised cost provides a more relevant presentation of the entity's activity.

Hence, the CNC welcomes the elimination of the held-to-maturity category and its tainting rules, which results in the classification of quoted debt instruments by default as available for sale in order to avoid such restrictive rule whereas those instruments are actually managed on a cash flows basis. It will enable debt instruments (quoted or not) to be measured consistently with the business model of the entity.

However, the CNC has concerns about the limitation of the amortised cost category to instruments that have only "basic loan features" (see Q2) and the way some hybrid instruments are accounted for (see Q4). The CNC believes that all instruments currently classified as loans & receivables or held to maturity should remain measured at amortised cost, which will not always be allowed according to the new conditions imposed upon this category.

Moreover, we believe that extending the use of fair value through profit & loss by limiting the amortised cost to basic instruments will lead to inadequate information provided to users as it will present in the profit and loss statement unreliable changes of fair value on complex instruments that often are or could become illiquid.

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 yield basis'? If not, why? What additional guidance would you propose and why?

(a) Basic loan features

As mentioned above, we are concerned that the amortised cost category is limited to only basic debt instruments since some debt instruments with predictable cash flows should be measured at amortised cost (in accordance with the business model of the entity), as it is currently the case under the current IAS 39, such as :

- Some perpetual instruments currently at amortised cost on the liability side :
    - o we wonder whether perpetual instruments with mandatory coupons where the amortised cost equals the principal amount in each period would qualify as instruments with basic loan features ;
    - o we are concerned that some perpetual instruments with contingent coupons (e.g. distributable profit, change in control, ...) would no longer be measured at amortised cost only due to particular (but usual) clauses that nevertheless have small (if any) effects on their fair values compared to basic instruments.

  On the asset side, we are concerned that investors in those instruments could be constrained by the accounting treatment applied in the issuer's accounts (according to the future debt versus equity definition). We wonder whether an instrument qualified as equity instrument in the issuer's accounts according to IAS 32 (the current standard and its revision project) could be qualified as a basic loan in the investor's accounts under the proposed revised IAS 39.

- Mezzanine and senior debt (but not the most senior one) (e.g. full-funded CDOs) currently classified as loans & receivables (see Q4b).

We are concerned that usual features or covenants included in retail loans could not comply with the guidance on basic loan features whereas they obviously should be considered as such.

For instance, the guidance in the ED addresses prepayment options but not extendable loans (option to extend the maturity of a loan while keeping the same other characteristics), which should be treated in a consistent manner.

Moreover, some examples provided by the ED are not consistent with the definition of basic loan features :

- we strongly disagree that "a financial asset that is acquired at a discount that reflects incurred credit losses" does not meet this condition for the following reasons :
    - o the discount reflects "the time value of money and the credit risk associated with the principal outstanding amount" as required by B1 and allowed by B3(iv) "including debt instruments issued at a discount or premium" ;
    - o there is no conceptual reason to make a distinction between originated loans (becoming doubtful) and purchased doubtful loans in a classification model (see IAS 39BC28) ;
    - o we disagree with the presumption that an entity that purchases a loan with incurred credit losses always believes that "the actual losses will be less than the losses that are reflected in the purchase price". An entity may merely intend to recover the expected cash-flows reflected in the purchase price consistently with its business model. We believe that the classification of any purchased loan must be made according to the business model used by the entity (with no predetermined assumption).
    - o we do not see why a purchased loan with incurred credit losses could not be eligible to the amortised cost category because it "creates exposure to significant variability in actual cash flows (ED §BC29)" whereas the level of variability in cash flows is not taken into account and does not prevent such a classification for a loan originated to a subprime borrower or securities issued by non-investment grade entities, which obviously are also subject to high variability in expected cash flows ;
    - o under an amortised cost measurement model, credit risk is properly addressed by the impairment model which provides information that is more useful to users than fair value.

Moreover, we understand that the Board considers moving to an expected loss impairment model, which will deal with credit risk for both doubtful and sound loans. Therefore, the distinction that the Board seems to make between the purchase of doubtful loans (not eligible to amortised cost) or the purchase of risky (but not doubtful) loans (eligible to amortised cost) would no longer be relevant.

- We are not convinced by the distinction made between “loans that are collateralised” (B6), which are eligible to the amortised cost category and “contractually subordinated interests (i.e. tranches) (B7) which are not eligible to this category (see Q4b).

(b) managed on a contractual yield basis

The notion of “contractual yield basis” is not clearly defined in the Exposure Draft.

However, we agree that selling an instrument before maturity (outside trading activities) should not prevent from “managing on a contractual yield basis” and consequently would not prevent from using the amortised cost category.

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 or financial 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?

As mentioned in Q1 and Q2 above, the CNC is opposed to limiting the amortised cost category to instruments with only “basic loan features”.

The CNC believes that the first relevant criterion to determine financial instrument classification is the business model. Then, the characteristics of the instrument should be taken into account to ensure that the business model can be applied consistently and make sure that the measurement approach provides decision-useful information. We believe that this is the process followed in practice when preparers determine the classification of financial instruments.

Hence, the amortised cost category should be available to financial instruments that the entity holds (or issued) for the purpose of collecting (paying) contractual cash flows. Collecting cash flows reflects the business model and making reference to contractual cash flows enables to take into account the characteristics of the instrument. Therefore, equity instruments, which encompass non contractual cash flows, should not be eligible to this category (however, cost associated with an impairment test could be relevant for unquoted equity instruments for which fair value cannot be reliably assessed – see Q8).

Moreover, as the amortised cost must provide decision-useful information to users, some hybrid instruments should not be fully eligible to this category, based on their characteristics. Embedded derivatives bifurcation requirements would achieve this objective (see Q4).

This alternative proposal made by the CNC is explained in detail in Appendix III.

Question 4

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

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose 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?

<u>(a) Embedded derivatives</u>

The CNC disagrees with the elimination of the embedded derivative requirements to bifurcate a hybrid instrument with a financial host since :

- oversimplification may obscure information on embedded derivatives (it would be more difficult for users to analyse hybrid instruments as a whole) ;
- it is preferable and useful to users to reflect the different nature and effect of each component of hybrid instruments that have significant different features (e.g. hybrid instruments with a loan component and a commodity index component) ;
- it will also lead to recognising some hybrid liabilities in their entirety at fair value through profit and loss and not only the embedded derivative, which will increase the recognition of own credit risk variation in profit & loss. As expressed in our comment to the DP “credit risk in liability measurement”, the CNC is strongly opposed to such accounting treatment.

Consequently, the principle of identifying and valuing embedded derivatives for hybrid financial instruments is justified in order to properly represent the nature and cash flows of each component of a hybrid instrument (i.e. enhance the understanding of the effect of the embedded derivative on one hand and of the host contract, usually held on a cash flow basis, on the other hand).

Hence, the CNC is in favour of maintaining the requirements to separate embedded derivatives when they are not economically closely related to the host contract. Moreover, the existing guidance must be improved. For instance, we believe that options to extend the remaining term to maturity (IAS 39AG30c) should be treated consistently with prepayment options (IAS 39AG30g) since those instruments are economically similar and consequently should not be bifurcated.

(b) Subordinated interests

The CNC disagrees with the proposed assertion that contractually subordinated interests do not have basic loan features and that only the most senior interest could be eligible to the amortised cost category. However, if they include derivatives, an analysis should be made to assess if the business model of collecting cash flows can be applied and if there are embedded derivatives wich would nead to be bifurcated.

Credit risk (including concentration of credit risk) is an integral part of loan features. Uncertainty related to credit risk related to loans at amortised cost is managed by the way of impairment. Hence, similarly to any loan, credit risks related to subordinated interest could be appropriately represented through an amortised cost (+impairment) measurement model.

Moreover, we consider that the treatment required for contractually subordinated interest is not robust and consistent with the main conditions related to the amortised cost category :

- Some subordinated interests could be senior interest but not the most senior one. In this case, we do not understand why these interests could not be eligible to the amortised cost category whereas they clearly have features regarding interest and credit risks similar to those of any collateralised loan and are usually held by investors in order to collect contractual cash-flows until maturity.
- Moreover, such a requirement could be easily circumvented by creating an SPE that would acquire a junior tranche (issued by another SPE) and then issue a single tranche of senior interest, which would meet the definition of the amortised category.
- The ED is unclear on whether subordinated loans or debt instruments issued by non-SPV entities could qualify as having only basic loan features.
- Moreover, we are not convinced by the distinction the Board seems to draw between legally subordinated interest and contractually subordinated interest. This could lead to different accounting treatments for economically identical instruments or could lead to different accounting treatments only due to different legal frameworks between countries.

Therefore, we would recommend the Board to eliminate such requirements.

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?

We welcome the Board’s decision to maintain a fair value option in order to eliminate or significantly reduce an accounting mismatch.

Question 6

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

Consistently with our opinion to retain the principle of bifurcation of embedded derivatives (see Q4), we believe that a fair value option should be allowed for hybrid instruments that contain one or more embedded instruments that should be separated if the bifurcation raises operational difficulties or significant costs.

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?

The CNC disagrees with the Board's proposal to prohibit any reclassification. This proposal seems to go in the opposite direction to the one followed in the latest measures taken by the IASB in response to the financial crisis, such as the issuance in October 2008 of an amendment to IAS 39 on reclassification of some financial instruments out of categories measured at fair value.

The CNC believes that a reclassification should be required when an instrument no longer meets the conditions related to its category, notably when external circumstances force entities to change their business model.

Any reclassification implies to provide disclosures in order to explain the reasons leading to such a reclassification and the amount of financial instruments reclassified.

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?

The removal of the fair value exemption for certain unquoted equity instruments will extend the use of fair value in the balance sheet to illiquid instruments for which fair value is not reliable.

The CNC believes that measuring illiquid instruments at fair value in the balance sheet is not relevant when fair value cannot be reliably measured. The current financial crisis has highlighted the weakness of fair value for such instruments. Moreover, it would be burdensome to require measurement of positive fair value changes that are not reliable (i.e. difficult and costly to assess) for a questionable benefit in terms of information, as the resulting information would not be reliable.

Hence, the CNC is in favour of maintaining the current requirements for unquoted equity instruments whose fair value is not reliable.

These instruments, which would be recognised at cost, should follow the same impairment principles as those developed in Q10.

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?

See Q8.

Question 10

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

The CNC considers that extending a "FV through OCI category (recyclable in P&L)" beyond equity instruments would improve financial reporting.

The removal of the Available-For-Sale category and the creation of a new category measured at fair value through OCI with no recycling in P&L raises the following concerns :

- The proposed change goes far beyond issues raised by the financial crisis which are mainly related to impairment. The CNC expressed in its comment letter to the FASB FSPs related to impairment that : "*we strongly support harmonising impairment rules for available for sale debt instruments with those applied to financial assets carried at amortised cost in order to provide more appropriate and comparable information in the income statement*." We also called for a **review of the circumstances leading to impairment**, in particular regarding equity instruments and the possibility **of reversing impairment on equity instruments**.
- The Board was asked by constituents to deal with impairment for available for sale instruments (both debt and equity instruments) and we note that the Board avoids to deal with this issue by creating categories eliminating the need for impairment testing : Fair value through P&L or through OCI not recyclable in P&L (limited to equity instruments). We are concerned that in order to avoid impairment testing, the Board is creating a wide category measured at Fair value through profit and loss which will increase volatility in P&L and another category measured at Fair Value through OCI (not recyclable in P&L) which is not providing relevant information to users.
- The CNC is not convinced of the decision-usefulness of such a requirement. Preventing recognition of realized gain or loss on sale and even dividends received in profit and loss could result in financial statements – especially the income statement - not being useful in presenting an accurate representation of performance, especially for the financial industry (insurance companies, banking industry) for which investment portfolio is significant and plays a key role in their financial performance. Moreover, it will create a discrepancy between the recognition of equities returns in OCI or retained earnings and the recognition of funding costs backing these investments in profit & loss, as well as expenses related to insurance contracts that should be covered by revenues on investments. This will also create a discrepancy for some corporates between decommissioning liabilities and financial assets (including equity investments) acquired to fund those obligations.

- This requirement will lead to the promotion of a unique statement of comprehensive income and the reduction of the relevance of net result as indicator of performance. Indeed, we understand from the July joint IASB-FASB meeting that "the IASB plans to consider that issue in September". This is a direction to which the CNC is strongly opposed. As expressed in our comment letter on the DP Financial statement presentation[3], "*The promotion of comprehensive income as the central measure of performance in lieu of net income has no proven conceptual justification and entails significant risks for financial markets. [...] Comprehensive income does not seem to answer the main objectives and characteristics assigned to financial statements :*

    - *Understandability : other comprehensive income items are transitory value adjustments and not financial performance items. Adding up other comprehensive income items, and therefore comprehensive income, can be a source of major confusion for the financial markets,*
    - *Predictability of future cash-flows : other comprehensive income items have no predictive value. They often are long term changes in value, not to be realised within the next periods, or that management has no intention of realising,*
    - *Assessment of management's stewardship : management's performance is neither internally nor externally assessed based on comprehensive income. This measure is not used in the value creation and entity valuation methods.*
    - *Comprehensive income includes virtual gains and losses of a highly hypothetical nature and sometimes for very significant amounts : using it as the central performance measure may only contribute further to financial market instability and increase the lack of confidence from users*."

We believe that, if the Board were to pursue with the proposals, a category measured at Fair Value through OCI should <u>not</u> :

- be limited to equity instruments only but may also includes other instruments such as debt instruments, held for the purpose of obtaining a gain on sale in the medium term due to change in value for instance ;
- forbid recycling in profit and loss any realised gain or loss (e.g. reception of interest or dividends, disposal, impairment).

We recommend that the Board deal with impairment principles for equity instruments with the following leading guidance :

- take into account investors' holding horizon in the assessment of impairment as requested by the G20
- permit the reversal of impairment : the CNC considers that there is no justification for not allowing the reversal of impairment on equity instruments. Moreover, it would enhance consistency with the treatment of impairment on debt instruments.

However, if the Board were unable to find a majority approval among constituents on a new impairment approach, we would recommend at a minimum that the current principles in IAS 39 remain but that reversal of impairment be allowed.

[3] CNC's comment letter to DP Financial statement presentation – 10 April 2009

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) 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?

See Q10 and Q7 (on reclassification).

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?

The CNC agrees that additional disclosures are needed to help users understand changes related to the implementation of a new standard.

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?

As already expressed in the general comments, the CNC would underline the difficulty to implement the phase I of the revision of IAS 39 without knowing the Board's decisions related to phase III of the project.

It would be unreasonable to expect entities to make irrevocable classification decisions about their financial instruments without knowing how the hedge accounting model will look like for instance. Therefore, we recommend that reclassification should be available on implementation of the other phases of the IAS 39 revision project.

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?

As already expressed above, the CNC is strongly opposed to an extended use of fair value and considers that a mixed measurement model attribute is relevant to provide decision-useful information. This mixed measurement model must be consistent with the business model.

The alternative proposal aims at measuring some quoted debt instruments at fair value through OCI by adding a third condition to the amortised cost category (i.e. definition of loans & receivables in IAS 39). Whether a debt instrument is quoted or not should not be taken into account to determine what could be measured at amortised cost. This category must be driven by the business model of the entity, i.e. the collecting of contractual cash flows. Quoted debt instruments held for the purpose of collecting contractual cash flows during the life of the instrument should be measured at amortised cost (as allowed in the approach proposed in the ED), such measurement providing the most decision useful information in accordance with the business model of the entity.

As a consequence, the CNC is strongly opposed to the alternative approach which is a next step towards full fair value measurement in the balance sheet.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

As expressed in the previous question, since the CNC is strongly opposed to an extended use of fair value, the CNC considers that neither possible variants of the alternative approach provide improvements in financial instruments reporting.

Appendix III

CNC's classification proposals

Because of the diversity of financial instruments on the one hand, and the diversity of management methods and "business models" applied to these financial instruments on the other hand, the CNC is in favour of a mixed model for classification of financial instruments.

2.1. Classification criteria

As asserted in the staff paper 5E submitted to the Board in May[4], "the objective of any approach that might be used to differentiate between instruments that are re-measured and instruments that are not has to be to ensure that the information presented is useful to users. Information is useful to users if it enables them to assess amounts, timing, and uncertainty of (i.e., predict) the future cash flows of the reporting entity and use the information within their valuation process to make economic decisions" (par. 9). "The way that an entity uses financial instruments may result in the actual cash flows to an entity being significantly different than contractually stated cash flows. Put simply, the business purpose can drive actual cash flows to an entity" (par. 29).

The Staff paper acknowledges that information on the predictability, including uncertainty, of future cash-flows of an entity, which is particularly useful for users, is mainly driven by the business model of the entity. Hence, this business model factor is relevant to define categories for financial instruments.

Business model enables to distinguish between (i) financial instruments managed on a cash flow basis for which initial value is recovered by collection of expected/contractual cash flows of the instrument, (ii) financial instruments held for trading purposes, (iii) financial instruments compulsorily held by the entity in order to comply with contractual or regulatory commitments which are required to be settled and measured in the balance sheet (liabilities) at the fair value of these underlying financial assets – such as unit linked contracts in the insurance industry, and (iv) medium or long term investment and other instruments.

The business model is different from management intent since it needs internal process, specific monitoring, reporting and control and must be identified as such in the internal organisation. Hence, this factor is not arbitrary and must be demonstrated in order to be used to determine the classification of financial instruments.

[4] IASB Staff paper AP5E Classification of financial instruments – a possible approach – May 2009

2.2. Determination of financial instruments categories

A business model approach

The predictability of future cash flows of an entity is mainly driven by the business model of the entity, which is the key factor to consider in order to classify a financial instrument.

As explained in the aforementioned paper[4], "the business purpose can drive actual cash flows to an entity" (par. 29) :

- If realisation of the value of a financial instrument is expected to occur by transferring it prior to contractual maturity, contractual cash flows may have weak predictive value for a user (par. 30).
- However, if the business purpose is to realise the financial instrument's value by way of receipt of the future contractual cash flows, then the greater the predictive value of contractual cash flows is likely to be (par. 31).

This distinction supports the use of a mixed model of accounting for financial instruments, with certain instruments measured at fair value in the financial statements, others being measured at cost, with recognition of impairment if appropriate.

<u>Contractual cash flow management basis</u> :

The financial instruments managed on a contractual cash flow basis refer to assets for which the initial value is recovered by cash flows rather than by disposal or transfer and to liabilities which are extinguished in a same way. Amortised cost is the measurement attribute which is the most appropriate for representing the return on these transactions and their cash flows.

<u>Fair value management basis</u> :

Fair value through profit or loss is the measurement attribute which is the most appropriate for representing the way held-for-trading instruments are effectively managed and evaluated. The financial instruments held for trading purposes refer to instruments held or issued:

- with a practice of short-term profit taking; and
- with the ability to be traded in active markets (i.e. liquid markets) ; indeed, illiquid financial assets cannot be effectively traded as illustrated in the recent financial market crisis and as a consequence should not be eligible to this category.

Conditions required for inclusion in the held-for-trading category take lessons to be learnt from the financial crisis. Some financial instruments classified in the category at fair value through profit or loss appear to be illiquid for various reasons including too specific contractual features, absence of an organised and active secondary market, …It will also bear answer to the request of the G 20 that accounting standards take into account liquidity and uncertainty issues, as well as investors' time horizon.

Fair value through profit or loss is also appropriate to measure financial instruments that must be held by the entity in order to comply with contractual or regulatory commitments towards a third party which are required to be settled and measured on the liability side of the balance sheet at the fair value of these underlying financial instruments. This is the case for financial instruments held by insurance companies issuing unit linked contracts : for this activity, the insurance company must own financial assets underlying the insurance contract, in order to back the contractual liabilities that will be settled at the fair value of these financial assets when the holder of the contract will ask for its settlement.

A third category :

Investment in financial instruments with a medium or long term perspective relate to a business model which is neither based on the recovery of cash flows nor on short-term profit taking. For such investments and additionally for other instruments that do not meet the previous business models, a third category is needed for which an appropriate measurement attribute should be determined. [see §2.4. below]

As a consequence, applying business model factors leads to the creation of the following categories :

- a) Amortised cost category : financial instruments that the entity holds (or issued) for the purpose of collecting (settling) contractual cash-flows.
- b) Fair value through P&L category : effectively actively traded financial instruments which are held for trading purposes by the entity and financial instruments compulsorily held by the entity in order to comply with contractual or regulatory commitments which are required to be settled and measured in the balance sheet (liabilities) at the fair value of these underlying financial assets.
- c) Third category : financial instruments that are held as investments with a medium to long term perspective or that do not meet the definition of amortised cost category or the fair value through P&L category.

A Business model must be evidenced, based on facts and circumstances, in order to be used as a factor of classification of financial instruments.

Moreover a fair value option in order to eliminate or significantly reduce an accounting mismatch should be introduced.

Derivatives specificity

We note that everybody agrees that derivatives that are not held for hedging purposes have to be marked to market. However, this does not lead mechanically to the conclusion that all derivatives in all circumstances must be measured on that basis. At this stage, we have to avoid preempting the conclusion of the future discussion on hedging (phase III of the revision of IAS 39).

Consistently, derivatives embedded in non-derivative instruments (or non-financial instruments) should follow the same accounting treatment than stand alone derivatives. Hence, they must be separated from the host contract and measured at fair value unless they are economically closely related to the host contract.

2.3. Application guidance on financial instruments categories

a) Amortised cost category :

This category includes non-derivative financial instruments with contractual cash-flows that the entity is managing to collect (settle). Thus, all debt instruments (quoted or not) are eligible to this category whereas equity instruments, which do not have contractual but discretionary cash-flows, are not.

Financial instruments classified in the amortised cost category are not prevented from a sale provided that was not intended at inception. This category is not subject to tainting rules.

b) Fair value through P&L category :

Actively traded financial instruments which are held for trading purposes include derivative and non-derivative financial instruments that are :

- acquired or incurred principally for the purpose of selling or repurchasing them in the near term ; or
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

Moreover, the ability to practice a trading activity must be demonstrated and is thus limited to :

- financial instruments meeting the following conditions related to liquidity :
    - they are negotiable on an active market. An active market is any market on which the market prices of the securities concerned are accessible at all times to third parties from a stock exchange or from brokers, traders or market-maker institutions or equivalent organisations that provide continuous buying and selling price quotations with spreads in line with market usage or, failing this, that carry out operations for significant amounts in securities of similar sensitivity, trading in which necessarily influences trading in the securities concerned ;
    - the market prices, accessible as described above, must be representative of actual transactions taking place regularly on the market under conditions of normal competition ;
    - or, when the instrument is not traded on an active market, all its risks can be transferred externally with instruments meeting the previous conditions. However, if almost all but not exactly all risks can be transferred externally by other instruments meeting the previous conditions, a suitable accounting treatment should be determined.

- internal organisation meeting the following conditions :
    - the institution is capable of sustaining a permanent presence on the market for the financial instruments included in the portfolio;
    - there is a significant volume of operations in the trading portfolio containing the financial instruments concerned;
    - the portfolio is constantly managed in a global manner, for example on the basis of sensitivity;
    - positions are centralised and results are calculated daily;
    - internal limits on the market risks incurred on the portfolio have been previously established.

Financial instruments compulsorily held by the entity in order to comply with contractual or regulatory commitments which are required to be settled and measured in the balance sheet (liabilities) at the fair value of these underlying financial assets :

These are all financial instruments held to allow the entity to comply with current commitments which settlement basis is contractually or regulatorily linked to the fair value of these financial assets. It includes financial instruments held by insurance companies for the purpose of unit linked business.

c) The third category includes for instance :

- equity instruments, for which there are no contractual cash-flows, not held for trading purposes but as a medium or long term investment ;

- debt instruments held with an intent to sell in the future (but not in the short-term) ;

- derivatives that fail to meet trading ability conditions.

These financial instruments are generally held for investment in the medium-term.

2.4. Measurement method for the third category

Measurement method

The CNC believes that accounting for fair value variations in profit & loss is only relevant for financial instruments held for trading purposes and actively traded or held in order to comply with contractual or regulatory commitments which are required to be settled and measured at the fair value of these underlying financial assets.

Hence, an appropriate measurement attribute should be determined for instruments classified in the third category taken into consideration the holding horizon and the liquidity of the instruments as requested by the G20.

For instance, the following measurement models could be explored :

- Value in use ;
- Lower of cost or market ;
- Fair Value through OCI (with recycling in P&L) ;
- Other measurement model...

Impairment model

If an instrument classified in the third category becomes impaired, this impairment should lead to the recognition of a loss in profit & loss, if not previously recognised according to the measurement method that would apply on a recurring basis.

The impairment model depends on the nature of the financial instruments :

- Debt instruments should follow the same impairment model than debt instruments classified in the amortised cost category, i.e. the amount of the total impairment related only to credit risk is recognised in profit or loss. This would enhance comparability between impairment related to these different categories.

- Equity instruments : as requested by the G20, investor's holding horizons should be taken into account. Hence, an impairment model taking into account this requirement should be determined.

Moreover, in all cases, **reversal of impairment should be allowed**.

2.5. Reclassification

Reclassification must be required when there is a change in the business model(s) used by the entity according to its strategy or if it no longer has the ability to support the intended business model (no more trading ability, no longer able to collect cash-flows, instruments becoming illiquid, settlement of the commitments under unit linked insurance contracts issued, etc.).

Reclassification implies to disclose relevant information to users to explain the reasons and consequences of such a reclassification.

2.6. Fair Value Option

A fair value option (through profit & loss) should be available in case of an accounting mismatch or for hybrid instruments containing one or more embedded derivatives (that should be separated).