Association pour la participation des entreprises françaises à l'harmonisation comptable internationale

Mouvement des Entreprises de France
MEDEF

IASB
30 Cannon Street
London EC4M 6XH
UK

Paris, July 8, 2010

Re: *Fair Value Option for Financial Liabilities*

We welcome the opportunity to comment on the IASB exposure draft dealing with Fair Value option for Financial Liabilities (the ED). We do, however, regret that the Board has not published a comprehensive set of proposals for the measurement of financial liabilities.

We are content that the IASB is examining the question of the change of credit risk in the variation of the fair value of financial liabilities. We agree that the profit for the period should not be affected by changes in own-credit risk, on the grounds that this does not provide any information which allows users to forecast future cash flows except in extremely rare circumstances Nevertheless, we would prefer an approach consisting of the freezing of the initial credit risk with no recognition of subsequent changes in this element which is never, or, at most, very rarely, realised.

We think that the amendments proposed in the ED are of the nature of an improvement aimed at a specific problem in current IAS 39 rather than a part of the IFRS 9 project. It would be helpful to some entities if the Board were to introduce a specific improvement to IAS 39 quickly and enable entities to use it.

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

Should you require any supplementary comments or explanation, please do not hesitate to contact us.

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Patrice MARTEAU	**Alexandre TESSIER**	**Agnès LEPINAY**
Chairman	Director General	Director of economic and financial affairs

Appendix to our letter on IASB Exposure Draft on Fair Value Option for Financial Liabilities

Question 1

Do you agree that for all liabilities designated under the fair value option,* changes in the credit risk of the liability should not affect profit or loss? If *you disagree, why?

We are very much in favour of the principle that the profit or loss of issuers of finance debt who measure that debt at fair value through profit or loss should not be affected by changes in own-credit risk. In our view, because the gains or losses generated by the own credit-risk element are realised extremely rarely, accounting for these changes in profit or loss does not provide the user of the financial statements with useful information which is predictive of future cash flows.

In our experience, finance debt issued by entities are intended to be kept outstanding in accordance with the contractual dates of payment in order to allow the entity to provide for the financing needs for which the debt is issued. Although the debt is repaid only on the due dates, it is sometimes managed on a fair-value basis as part of a risk-management strategy. The different risk factors such as, for example, interest-rate, exchange-rate, share-price and commodity-price risk, which make up these debt instruments – particularly structured debt instruments – and which can be laid off in an active market, are managed by entities in order to hedge themselves against the risk. Active risk management of this sort often leads the entity to opt for fair-value accounting for the liability or, in the case of certain groups of companies, to classify the liabilities as trading instruments under the current definitions of IAS 39. The own-credit risk is usually not hedged nor can it be laid off in a market. The variations in this risk element will therefore not be realised, except perhaps in those rare instances where the debt is restructured. In our experience, the buying-back of own debt is a very rare occurrence, as it is difficult to arrange and generates little long-term value for the entity.

We agree, therefore, that, no finance debt intended to provide the entity with durable financing should give rise to the recognition of gains or losses in profit or loss as a result of variations in own credit-risk.

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss, unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

We are aware of some confusion about potential mismatches for insurance companies because fair values of contracts could be linked with fair value of underlying financial assets (for such called unit-linked contacts or for all others asset and liability matching in absence of unit linkage).

We understand is not the Board's intention to reflect in OCI change in fair value of such liabilities due to change in underlying asset's credit risk. It should be précised in the forthcoming standard.

It may also exist some situations where fair value of assets includes an element that reflects the entity's own credit risk. In this case we agree with the pragmatic Board's proposals.

Question 3

Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

We agree that the portion of the fair value change that is attributable to changes in own-credit risk should not affect profit or loss unless the liability is held for trading and this component could be realised within contractual cash-flows. This element of the change in fair value is, of course, caused by the proposed requirement for such debt to be measured at the "full" fair value rather than at a value which excludes the effect of changes in the liability's credit risk.

We think that the initial own-credit risk should be frozen rather than revalued at each reporting date. No change in credit risk would be accounted for under this approach. We disagree with the recognition of the change in own-credit risk for the following reasons.

Entities manage only those risk elements that can be realised on an active market. We think that only those risk elements which can realistically give rise to realisable cash flows should be recognised in the balance sheet as these are the only elements which provide pertinent information about future cash flows. The change in fair value of own-credit risk is normally not realisable and thus we do not think it should be accounted for.

We think that those who argue in favour of the "full" fair value of finance debt in the balance sheet are also generally in favour of the measurement of all financial instruments at fair value. This is not consistent with the mixed measurement model that the IASB has adopted. We think the principal justification for the "full" fair value approach is based on the theory of the transfer of wealth between the owners and the providers of debt finance. We do not agree with this argument because of the extremely small likelihood of the gain or loss being realised. On the assumption that the entity is a going concern and in the context of an accounting model based upon the reality of the entity's business model, we think, that such finance debt is very rarely, , repurchased (and we note that this is the Board's view, as expressed in paragraph BC 37. In our view, the balance sheet should not reflect such hypothetical transactions, and information about the potential cost of repurchase and refinancing is better placed in the disclosures alongside discussion of long-term financial strategy and the risks the entity face from the economic environment.

Finally, the volatility induced by the change in the credit risk of the liability, which constituents believe should not affect profit or loss, should not affect OCI or equity either, in our view.

Question 4

Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

As discussed above, our preference is for a freezing of the initial own-credit risk. If, however, the Board were to pursue the proposed revaluation of the credit risk element, we would prefer the "one-step" approach to the accounting for it.

While we do not contest the usefulness of the information provided under the "two-step" approach, we think that it would be more consistent with the overall approach of the ED and less confusing to the user to provide it by means of disclosure rather than by presentation. It has been tentatively decided that the change in own-credit risk should not be recognised in profit or loss. It seems unnecessary therefore to clutter up that part of the statement of comprehensive income with a figure including this effect and a second figure removing it. This can only be detrimental to the user's understanding of the financial statements.

In our view, the profit or loss statement should be a coherent whole which presents in an ordered and helpful manner only those elements which are relevant to an understanding of the entity's performance. It should not be a proforma display of individual elements amongst which the user has to find his way by picking out those elements which might, or might not, be useful to his understanding.

Question 5

Do you believe that the one-step approach is preferable to the two-step approach? If so why?

As discussed in our response to Question 4, we believe the "one-step" approach provides the relevant information in a clear way and is therefore preferable.

Question 6

Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

If it is decided to recognise the change in the own-credit risk, then we believe that this should be recognised in other comprehensive income (OCI).

In our opinion, the only changes that pass directly in equity should be those identified in current IAS 1. We do not agree that the change in own-credit risk results in a transaction with the owners of the entity, particularly as it is very rare that such changes result in a realised gain or loss. Furthermore, we do not understand why this change in valuation is different from other changes which are taken to OCI before being treated as changes in equity, such as gains or losses arising from foreign exchange translation, changes in actuarial assumptions or derivatives used for cash flow hedges. Providers of debt finance are not owners, and we find the argument that this is a transfer of wealth curious.

Question 7

Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income should not be reclassified to profit or loss? If not, why and in what circumstances should be reclassified

We are concerned by the discussion laid out in paragraphs BC 37 – 38, which implies that the IASB has taken a decision of principle that recycling should not be permitted as, in the Board's view, gains and losses should be recognised only once. In our view, however, the recognition of a gain or loss in OCI should not be assimilated to recognition in profit or loss, as these two parts of comprehensive income have fundamentally different purposes and characteristics. We therefore once again encourage the Board to undertake urgently a thorough review of the notion of performance and the significance and role of net profit for the period, OCI and recycling. We fear that without such reflection there is a risk that decisions about the location and treatment of gains and losses can only be inconsistent between accounting standards.

We think that it is very unlikely that the variations in own-credit risk will actually be realised for the vast majority of finance debt. It is for this reason that we believe that the freezing of the initial spread is the most appropriate and pragmatic method to deal with own-credit risk. Nevertheless, accounting standards should be developed not only to deal with the most likely and common transactions but should also allow preparers to devise pertinent and acceptable solutions for all transactions.

If an entity which does not opt to measure its financial debt at fair value decides to repurchase its outstanding finance debt, the impact of the change in own-credit risk since inception will go entirely to profit or loss. In contrast, an entity which has opted for the fair-valuing of financial liabilities will never see the impact of such a repurchase in its profit or loss. This renders the performance of the two entities incomparable and this seems unacceptable to us, even if it can be expected to occur only extremely rarely. We therefore think that recycling of any cumulative gains or losses from own-credit risk should be mandatory when the related debt is repurchased or reimbursed before the contractual due date.

Question 8

For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead?

We agree that this is a pragmatic approach and is acceptable.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

We understand that the Board will undertake a comprehensive review of the effective dates of all new and amended IFRS in preparation of the 2011 "stable platform" and will consult constituents on its conclusions. We reserve our judgement on the questions raised above pending that consultation.

Nevertheless, we think that the amendments proposed in the ED are of the nature of an improvement to eliminate a specific problem in current IAS 39 and are independent of the completion of IFRS 9. We think it would be opportune and helpful to some entities if the Board were to introduce the proposals as a specific amendment to IAS 39 quickly, and allow entities to take advantage of it.

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

We agree with retrospective application of the proposed amendments.

Although the eligibility conditions for the fair value option in IAS 39 have not been changed, the accounting for the change in own-credit risk has been relocated from profit and loss to OCI. We think that entities should be permitted to re-examine the choices made in the past and potentially change the option made in order to avoid any unforeseen and detrimental consequences of the proposed amendments and improve comparability

Other comments

Development of a common principle for the recognition and measurement of financial instruments

We regret that the Board has not taken the opportunity with this ED to develop a single model for the recognition and measurement of both financial assets and financial liabilities. In our view, it is possible and desirable to arrive at a robust and relevant model which can be applied to both.

However, we do not find the model currently proposed for financial assets under IFRS 9 – Phase 1 to be satisfactory and we think it should not yet be applied to financial liabilities. In our view:

- The restrictive and simplistic definition of the conditions to be satisfied for a financial instrument to qualify for measurement at amortised cost would lead to too many items to be measured at fair value if applied to financial liabilities (almost savings accounts governed by regulation, debt which interests are indexed on non financial variables as EBITDA; perpetual debt instruments with non mandatory payments of interest ……).

- The business model should be given more weight in the determination of the classification of financial instruments;

- Bifurcation is essential not only for financial liabilities (as decided by the Board) but also for financial assets, for the reasons discussed in our response to the exposure draft on [IFRS 9- phase 1]; and

- We reiterate our objections to the elimination of the cost exemption for financial assets and financial liabilities for which a reliable fair value cannot be determined.