14 October 2002 **CL 43**

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sirs,

MAZARS RESPONSE ON THE EXPOSURE DRAFT OF PROPOSED AMMENDMENTS TO IAS 32 AND IAS 39

The Mazars Group has offices in 51 countries world-wide. European members of the Mazars Group have formed an IAS taskforce which regularly meets to discuss technical issues as a group. The European members' taskforce, which currently includes technical representatives from Mazars' offices in France, the United Kingdom, the Netherlands, Belgium, Italy, Spain and Germany, has recently considered the Exposure Draft of proposed amendments to IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Measurement" and wishes to make the following response to the International Accounting Standards Board on behalf of Mazars' offices in the countries listed above. Our comments include the specific issues raised by the Board in the Exposure Draft together with a number of other significant matters.

IAS 32

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22 and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

We concur with a substance based approach. However, we believe the proposed amended grey text in paragraph 19: "and without regard to probabilities of the manners of settlement when the instrument is first recognised" should be removed. We consider that the probabilities of the manners of settlement is one part of the overall substance that would be taken into account in determining the classification of a financial instrument on the issuer's balance sheet and therefore should not be ignored completely in assessing the correct classification as either a liability or equity when first recognised.

Question 2 - Separation of liability and equity elements (paragraphs 28 and 29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

Yes, we would strongly favour this approach since, as the equity element is often the most difficult amount to measure, it would be best to value this part of the compound instrument as the residual element after determining the fair value of the liability element.

Question 3 - Classification of derivatives that relate to an entity's own shares (paragraph 29C - 29G)

Do you agree with guidance proposed about the classification of derivatives that relate to an entity's own shares?

Yes, we agree with the proposed guidance, which we believe adds clarity when considering the classification of derivatives that relate to an entity's own shares.

Question 4 - Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments?

(Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

We would consider it would be useful to have all of the guidance in one place rather than having to jump around between the two standards but believe that there are also other important issues to address before issuing one "comprehensive" standard. Such issues include:

- improving the links between IAS 30 "Disclosures in the Financial Statements of Banks and Similar Financial Institutions" and IAS 32 which we consider to be unclear at present;
- distinguishing between the required discloses of banks or similar institutions and non-banking companies, since the risks of such entities are not managed in the same way; and
- providing more examples of illustrative disclosure . We refer you to the Appendix of FRS 13 in the UK which provides illustrative disclosures for (a) a simpler company (b) a more complex company and (c) a bank or similar institution as the sort of illustrative disclosure we would welcome for IAS 32 (and IAS 39).

Moreover, we consider that merging both standards into one comprehensive one would need to enter into an exposure draft process wish could take undue time.

IAS 39

Question 1 - Scope: loan commitments (paragraph 1(i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

We agree that loan commitments (that cannot be settled net and the entity does not designate as held for trading) should be excluded from the scope of IAS 39 and should be accounted for in accordance with IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”. However, if loan commitments are to be exempted from IAS 39 we would stress that they should be subject to accounting principles regarding impairment, to keep the accounting treatment consistent between loan commitments and loans originated by the entity.

Question 2 - Derecognition: continuing involvement approach (paragraphs 35-37)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39?

If not, what approach would you propose?

We believe that applying a “continuing involvement approach” without addressing the problems of measurement will be potentially dangerous. We would therefore not be in favour of changing the rules without considering all the consequences of the change first in more detail and especially:

- more explicit operational guidance concerning partial or total derecognition
- detailed valuations rules of the part that is not recognised
- clarification of the definition of “pass through arrangements”

Question 3 - Derecognition: pass-through arrangement (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

The definition of a "pass through arrangement" raises questions, notably when applied to SPEs. If it were applied as described in the example B4, the new definition of pass through arrangements would empty SPEs from most of their assets. This would be a major change on a very sensitive issue. We believe that such a change cannot be made without a complete due process on its implication.

Question 4 - Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Whilst we acknowledge the rationale given in C58 – C63 for permitting entities to designate any financial instruments irrevocably at initial recognition as an instrument that is measured at fair value, we have strong reservations about adopting a wide-ranging use of fair values which in practice is unlikely to aid either reliability or comparability of financial information and could lead to dangerous accounting practices.

In addition, we do not agree that an initial decision to classify a financial instrument at fair value should be irrevocable since we can envisage scenarios where reclassification to another category (which is measured at amortised cost) may be appropriate and should thus not be totally outlawed in this way.

Question 5 - Fair value measurement considerations (paragraph 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95-100D of the Exposure Draft? Additional guidance is included in paragraphs A32-A42 of Appendix A Do you have nay suggestions for additional requirements or guidance?

We agree with the guidance issued in relation to measurement at fair value.

However, as auditors, we still consider that the key problem is that fair value measurement may be open to manipulation when the financial instrument is not traded on a liquid market or when valuing embedded derivatives (when the host contract is not itself marked to market) which are based on multiple indices. We would therefore welcome further guidance on the use of valuation models when no market value is available.

Question 6 - Collective evaluation of impairment (paragraphs 112 and 113A-113D)

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

We agree with the principle of collective evaluation for impairment purposes. However, we consider that the proposed approach may be difficult to apply in practice and therefore believe that further consideration should be given by the Board as to the correct methodology to be used in this area, including possible alternatives (e.g. the "risk premium approach"). Moreover, we consider that the exclusion of individually assessed assets from the basis of collective evaluation without modifying expected cash flow loss rate is not correct.

Question 7 - Impairment of investments in available-for-sale financial assets (paragraph 117-119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

We strongly disagree. We believe that this approach should not be different from that applied to other assets. If the facts that led to the impairment loss in the first place reverse then the impairment losses should also reverse. A one way (downwards) treatment would seem to be inappropriate and therefore we would request that the original text in para. 119 be re-instated.

Question 8 - Hedges of firm commitments (paragraph 137 and 140)

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

We disagree in part with the proposal, on the basis that we would welcome an option approach which would allow a firm commitment to be either accounted for as a cash flow hedge <u>or</u> a fair value hedge as long as the same accounting method is applied consistently to the same type of transactions.

We would also like to add that accounting for a firm commitment as a cash flow hedge does not solve the problem when there is uncertainty on timing. In particular guidance on hedging when dealing with construction contracts under IAS 11, where contractual terms do not necessarily link to revenue recognised in the income statement, would be welcomed by the industry.

Question 9 - ' Basis adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain *in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?*

We disagree. We believe that this proposal will unnecessarily complicate accounting for forecast transactions entered into by companies. We consider that the existing rules which remove the hedge gain or loss from equity and recognise it as part of the carrying amount of an asset or liability should be retained.

Question 10 - Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognised transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied.

We agree with the proposals in paragraph 171B, which would provide consistency in presentation rather than having a mixture of new and old derognition rules.

OTHER COMMENTS

We also welcome this opportunity to raise the following additional comments:

Scope paragraph

We consider that the existing scope of IAS 39 is not always well defined and we consider that the proposed amendments to the scope in the Exposure Draft do little to add clarity. We would like to see the Board revisit the scope paragraphs having due regard to the many different industries that have to apply IAS 39. (Also see comments below on insurance and energy sectors).

Complexity of hedging documentation rules

Whilst acknowledging the importance of clear rules on hedge accounting, we do not believe that an accounting standard should drive entities' hedging policies. We would therefore like to see the requirements relating to the documentation that is needed to apply hedge accounting simplified. One area where we support simplification would be for one-off effectiveness testing (rather than having to prove effectiveness at all times) in situations where at first designation the hedging relationship is perfectly effective (near to the so-called "short-cut method" discussed in US SFAS 133)

Internal transactions

We believe that additional consideration should be given to situations where companies operate "strictly" separate management of their trading book, so that internal transactions are treated in the same way as transactions with external parties, subject to strict limitations on internal control, trading limits and realising of arm's length transactions.

Energy Companies

We also take this opportunity to highlight the situation of re-optimisation of power facing end-to-end energy companies (i.e. production to retail) and the resultant difficulties that IAS 39 causes when trying to meet their own use physical requirements. Additional guidance would be welcome in this unique situation as part of the "questions and answers" guidance supporting the Standard.

Insurance companies

On the basis that an international standard on insurance contracts will not be finalised by 2005 the insurance sector would welcome some "interim" solutions in IAS 39 especially in relation to scope and valuation requirements to ensure that their financial statements are meaningful We suggest extreme caution in this area to make sure that assets and liabilities are addressed jointly and coherently.

If there are any matters arising from this letter that you would like to discuss, please do not hesitate to contact either Steven Brice (Mazars' IAS Taskforce member – UK) on 0207 220 3231 or Françoise Flores (Mazars' IAS Taskforce member – France) on +33 (1) 49 9760 00

Yours faithfully,

Signed on behalf of Mazars by Patrick de Cambourg (CEO)