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INTERNATIONAL ACCOUNTING STANDARDS BOARD
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EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO IAS 32 AND IAS 39

Ladies and Gentlemen,

Please find below our answer to your invitation to comment on the above mentioned exposure draft.

1. GENERAL COMMENTS

In its introduction to the improvements of IAS 32 and IAS 39, the Board has set out the following objectives :

- improvement of the two existing standards,
- reduce some of the complexity by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the standards key elements of existing SIC interpretations and IAS 39 implementation guidance.

We welcome the revision that has been done and, in particular, the integration of SIC interpretations and implementation guidance into the standard. The Board has also mentioned that the revised standards would be in place for a considerable period. We support that objective as it will allow the Board to work on the "performance reporting project", which has to set the fundamental principles for measuring and recognising the performance of financial instruments.

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However, we consider that some revision proposals have generally not reduced the complexity of the standards. Furthermore accounting conventions, which sometimes do not reflect the economic substance of the transactions, have been established. We think in particular of:

- the probabilities of different manners of settlement which, is based on the presumption that certain events would occur,
- the classification of the entity's own equity instruments, which are to be recognised under equity only if the contract will be settled for a fixed number of the entity's own equity instruments,
- the possibility to designate any financial asset as trading on inception,
- the prohibition of the reversal of impairment for AFS assets,
- the treatment of hedges of foreign commitments as fair value hedges, and
- the repeal of the "basis adjustments".

As regards the treatment of foreign commitments as fair value hedges and the repeal of the "basis adjustments", we understand that such changes have been implemented to converge to US GAAP. However, the convergence should not result in complex and difficult to apply solutions and, if a choice should be made for obtaining a practical solution, we do not see why US GAAP could not be amended.

We also recommend that the Board reconsiders the broadening of the hedging base for non-derivative financial assets in the area of commodities and CO_2 trading rights.

Finally, the increased complexity of the standards will result in implementation difficulties for the preparers and we therefore recommend that the revised standards become effective during 2004 assuming they are published well in advance.

2. ANSWERS TO SPECIFIC QUESTIONS AND OTHER POINTS

IAS 32 – Financial Instruments : Disclosure and Presentation

Question 1 - Probability of different manners of settlement

No. We disagree with § 22A that classifies as liabilities those financial instruments whose settlement depends on the occurrence or non-occurrence of certain events when the issuer does not have an unconditional right to avoid the settlement in cash. The current wording of § 22A implies a presumption that the events triggering the settlement in cash would occur, whereas it is very often not possible to make such a presumption at inception of the financial instrument.

We consider that ignoring the probability of settlement is in contradiction with the substance over form qualitative characteristic of the Framework. Therefore we propose to include a clause similar to that of SIC 5 § 6 whereby the probability of settlement in cash should be considered at inception and, if such probability is remote, then the instrument should be classified as equity.

We also have some reservations with § 22B regarding puttable financial instruments and we consider that the probability of settlement in cash should also be considered. While that probability is almost certain in case of mutual funds because the holder has no other choice than receiving cash or keeping his instrument, such probability is not as certain in case of instruments such as bonds with warrants because, depending on the evolution of the financial markets, the holder may either put the bonds back to the issuer for cash or exercise the warrants and receive shares.

Question 2 - Separation of the liability and equity elements of a compound instrument

Yes. We agree that the liability element should be measured first and that the equity element is residual. That method is in accordance with § 49 (c) of the Framework that defines equity as residual.

Question 3 - Classification of the derivatives that relate to the entity's own shares

No. We disagree with § 29C ss. whereby derivatives on own shares shall be classified as equity if and only if the contract will be settled for a fixed number of the entity's own equity instruments. Such instruments do not meet the definition of a financial liability in the sense that the entity is not required to deliver cash or another financial asset to another entity. Further there is no exchange of financial instruments with another entity upon net settlement in shares. Paragraph B22 of the basis for conclusion explains that the purpose of the proposed change is to clarify the treatment of the entity's own derivatives. While this aim is laudable, the proposed guidance results in an arbitrary accounting convention that does not reflect the economic substance in the case of net settlement in cash or shares. Furthermore, the requirements assume that the issuer's practices would continue while they could change. Thus, material adjustments could result upon settlement of the instruments. Therefore we would recommend measuring the derivatives on own shares with regards to their economic characteristics and treating the entity's own derivatives as equity in case of net settlement in cash or in shares.

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

While that proposal seems attractive at first sight, we do not believe that much would be gained because the amalgamation of principle based disclosure and presentation with ruled based recognition and measurement could be rather odd. Furthermore we are concerned that this additional drafting work would delay the publication of the revised standard. Therefore we do not agree with such consolidation.

Other points

Synthetic instruments (§ 51) – We do not understand why the last sentence of § 51 concerning the relationships between the components of synthetic instruments was deleted. We have found that sentence useful in preparing our disclosures concerning those instruments.

The **disclosure** of the book value of **financial instruments exposed to interest-rate risk** broken down **into six maturity periods** (§ 64) seems to be excessive. We recommend staying with the present, quite adequate analysis (< 1 year, 1-5 years and > 5 years).

Fair value measurement - § 77A requires that, when the fair value cannot be measured reliably, "the range of estimates within which fair value is likely to lay" should be disclosed. That sentence should be deleted because the existence of a range is, in our opinion, an evidence that a fair value is available and it could be worked out, e.g., on the basis of a mathematical average.

The **deletion of § 80** of the current standard concerning the **reference to the presumption of going concern** is unfortunate since it is useful to reiterate that values based on a distressed sale are not an evidence of fair value. This could be important in connection with instruments whose transactions are infrequent because some of them could have been related to a distressed sale.

Other Disclosures § 93A (b) – We consider that the disclosure concerning transfers of assets that do not qualify for derecognition is far too detailed since the transferor has to publish nearly all the details of the transactions which would load the notes with limited value for the users. We consider that the important fact to disclose is that the transferor has contracted a financial liability on the basis of assets that it has retained on its balance sheet. We recommend to limit the disclosure to:

- the nature of the asset(s) transferred, e.g. receivables portfolios, and
- the nature and maturity of the related liability, e.g., obligations under factoring agreements.

Thus the users would be informed but without committing the preparers to disclose all the particulars of the transactions.

Transitional provisions – We recommend that "grandfathering" should apply to items that were recognised as equity under the old standard and that should be recognised as liability under the new standard.

IAS 39 – Financial Instruments : Recognition and Measurement

Question 1 - Scope : loan commitments

Yes, we agree.

Question 2 - Derecognition : continuing involvement approach

We agree in principle but we have some concerns about the practical application of the continuing involvement concept and about the issues of retention of the credit risk. In general we consider that the derecognition part of the standard would need additional clarification and that the preparers would benefit from more concrete practical examples in the appendix.

The current IAS 39 is based on the notion of loss of control (§ 35 ss.) which has been substituted by that of continuing involvement approach. However control surfaces again in §§ 37 and 38 as "re-acquiring control", so the change does not seem to be a clear one. Moreover, in § 42, it would be desirable to cover whether or not the retention of voting rights in an asset is a substantial factor to consider in determining whether it can be de-recognised.

We also consider that the notion of partial derecognition in § 41 ss is theoretically acceptable but that it would require practical examples in the appendix.

As regards the retention of credit risk we would also recommend that some examples from the commercial and banking sectors regarding factoring and forfeiting be prepared. In particular such examples should clarify what is meant when one might pass on receivables subject to recourse due to inadequate documentation (veritas risk) affecting, on the basis of experience, some 2% of receivables. Does the continuing involvement approach prevent derecognition of all of the receivables – which seems rather far from the economic reality of the situation – or does it still permit derecognition with a 2% provision for recourse?

Question 3 – Derecognition : pass through agreements

Yes, we agree subject to our remark under question 2 (see the penultimate paragraph in our answer to that question).

Question 4 - Measurement : fair value designation

No, we disagree. Under IAS 39, financial assets are classified into four categories and, among these both the trading and available-for-sale are measured at fair value. However the standard currently acknowledges that, when an instrument is classified as trading, its fair value gains and losses are immediately recognised in the income statement, while such gains and losses are recognised in equity for an AFS financial asset until such asset is sold or otherwise disposed of. The existing classification has the merit of recognising the fact that some enterprises manage their financial assets by portfolios and that some financial assets are acquired for immediate profit taking (i.e. the trading ones) while others may be disposed of depending on the needs of the enterprises (the AFS ones). We do not perceive therefore the benefits of the proposed change apart from a "simplification" the drawback would be not to reflect the economic nature of the portfolios. We also consider that such a "simplification" could be a first step towards a full fair value accounting to which we object.

Question 5 – Fair value measurement considerations

Yes, we agree.

Question 6 – Collective evaluation of impairment

We basically agree but we consider that the standard should clearly distinguish the case of industries where global bad debts allowances are the general practice because they have portfolios with a large number of debtors (e.g. retail banking, consumer goods) from other industries where the individual assessment of impairments should be the general rule (e.g. heavy industry, aerospace, corporate banking).

Question 7 – Impairments of investments in available-for-sale assets

No, we do not agree. While it is logical to reverse the losses previously taken to equity when an AFS investment is impaired, we do not understand why, in case of an improvement of the financial situation of the debtor, the gains should be taken to equity. We consider that this asymmetrical treatment is excessively conservative and does not reflect the economic situation. Therefore we recommend that, in such a case, any subsequent fair value gains be taken to the income statement up to the amount of the impairment loss previously recognised to the income statement.

Question 8 – Hedges of firm commitments

No, we do not agree. While the proposed accounting treatment for firm commitments has the same effect as the basis adjustment, it results in recognising the fair value of hedged firm commitments while unhedged commitments are currently not recognised and would presumably continue to stay off balance sheet, which results in a conceptual inconsistency between economically similar situations. The so-called "commitment" to be recorded in the balance sheet does not readily represent anything: such a meaningless position does not fit with the IASB's reluctance to recognise timing accruals and deferrals in the balance sheet. The proposed treatment is also more complicated from a practical standpoint since it duplicates the entries whereas, with the current treatment as a cash flow hedge, the opposite entry of the derivative simply goes to the hedging reserve.

Furthermore, the IASB proposals do not address the issue of hedged transactions that are still cash flows hedges such as future export sales. Also the problem remains when a forecasted transaction is hedged before it is committed. For example, an enterprise may want to hedge its raw material needs for a given period but firm orders have not yet been placed with the suppliers. So the hedge effectiveness would not be guaranteed when the company places the firm commitment later on. It would make much more practical and conceptual sense to leave the definition of fair value hedges in consistent terms related to accepted recognised assets and liabilities and treat firm commitments and forecasted transactions in the same way, as cash flow hedges as now. They are economically identical. The proposal is an excellent example of where converging **to** US GAAP would result in a lower-quality solution than IAS currently offers, as is the proposal to eliminate the "basis adjustment" (see under question 9 below). If, to promote convergence, a choice needs to be made between US GAAP and IASB solutions, then the current IASB solutions should be retained in the previously mentioned two cases and US GAAP should be changed.

Question 9 – "Basis adjustments"

No, we do not agree. The basis adjustment approach properly reflects the economic reality of the hedge, namely that the entity has protected and fixed the expected value of the cost or revenue. Furthermore, the recording of the value changes in equity and especially their transfer to income over a period of time are much more complicated from a practical book-keeping viewpoint.

If the Board decides to proceed with this unfortunate idea, it should clearly state that the transfers from equity reduce the related operating expense such as depreciation, cost of goods sold, etc.

Question 10 – Prior recognition transactions, transitional provisions

No we disagree that an asset that was derecognised under the old standard be reinstated to the balance sheet on transition to the new standard. We consider that such a restatement would be cumbersome and would not bring real benefits. We recommend that "grandfathering" should apply.

Hedges of non-financial items - Commodities

Paragraph 130 has been modified to add an example of the hedge of Brazilian coffee using a forward contract to purchase Columbian coffee. We welcome this addition that clarifies that hedge accounting may apply to such transactions provided that their effectiveness can be demonstrated. While the modification of § 130 acknowledges that a derivative on one quality of commodity (the Columbian coffee) can hedge the price exposure on another quality (the Brazilian coffee), we still have an issue with the clause of § 129 (b) which says that when the hedged item is a non financial asset, it has to be designed as a hedged item "in its entirety due to the difficulty of isolating and measuring the appropriate portion of cash flow and fair value changes attributable to other risks other than foreign currency risks".

In effect, the risks attributable to both Brazilian and Columbian qualities of green coffee are identical, i.e. they are both subject to, for instance, price volatility resulting from natural events, and from supply and demand fluctuations. In the case under review, the price of the Brazilian coffee will be obtained by paying a "differential" against the forward price of the Columbian coffee, such differential is an executory contract and it cannot be hedged.

Therefore we consider that, there is no "difficulty in isolating and measuring the appropriate portion of the cash flows" and that sentence should be removed from IAS 39 § 129 because the company is exposed to the price fluctuation of two components, i.e., the price of the Columbian coffee, for which there are hedging instruments (typically futures) and the price of the Brazilian coffee, which is obtained through the payment of a differential and for which there is no hedging possibility. It is indeed possible to assess separately the price fluctuations of the Columbian coffee and of the differential for the Brazilian coffee. Thus the futures should be deemed to be a partial hedge, i.e., a hedge of the Columbian component of the ultimate purchase of the Brazilian coffee. IAS 39 should be modified to allow that partial hedge designation in the case of commodities since it reflects the nature of the exposure being hedged and it would greatly simplify hedge effectiveness calculations.

Please also note that, in reality, coffee futures are based on generic qualities of coffee such as robusta or arabica and not on specific geographical origins, which are obtained by the payment of a differential as specified above.

Hedges of non-financial items – CO_2 trading rights

According to IAS 39, § 122, a non-derivative financial asset or liability cannot be used for hedge accounting purposes, except for hedges of foreign currency risks. This restriction appears to be quite arbitrary, without any conceptual foundation. To consider an example with the current issue of accounting for CO_2 trading rights, we believe that the restriction could have negative consequences if CO_2 trading rights do not meet the definition of derivatives.

Other points

Scope § 1 (a) - We have already negatively commented on the limitation of 12 months for held-for-sale acquired subsidiaries in our response on the other "Improvements" draft (please see our letter dated 13 September 2002).

The **wording** of the last sentence of the definition of **held-to-maturity investments** (§ 10 p. 145) should be changed as follows: "other than those that the entity upon initial recognition elects to designate as trading or that meet the definition of loans and receivables originated by the entity or of available-for-sale". An entity cannot elect to classify a financial asset as available-for-sale since that classification is residual.

Paragraph 110A says that a **significant prolonged decline in the fair value of an investment in an equity instrument** below its cost is also an evidence of an impairment. If we have understood the requirement correctly, in such a case the equity instrument should be impaired below its fair value. That contradicts the going concern convention unless there are doubts about the solvability of the company in which the equity investment was made. We consider that the standard should say "a significant and prolonged decline in the fair value of an investment in an equity instrument below its cost may be an evidence of major financial difficulties of the issuer that could lead to an impairment below fair value".

Paragraph 160 - We assume that the last sentence added to that paragraph relates to impairment in respect of the hedged item. However, this is not at all clear from the wording. We suggest some explanation is given of the intention behind the rule.

Effective date and transitional provisions

We know from the experience of the current IAS 39 and of its implementation guidance that the implementation time is always under-estimated. Therefore, we cannot support the introduction of the revised standards in 2003 and we recommend that the effective date be fixed during 2004 subject to the publication of the final standards well in advance. As stated above, "grandfathering" should apply to a change of classification between debt and equity and to the changes in the derecognition rules.

Thank you very much for your attention to the above.

Yours very truly,

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