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

Mouvement des Entreprises de France MEDEF

CL 31

Sir David TWEEDIE
Chairman IASB

IASB
30 Cannon Street
LONDON EC4M 6XH
UK

JK/SJ/10.2002/
RE : Exposure draft on Amendments to IAS 32 & 39

Paris, Thursday October 10th, 2002

Dear Sir,

We would like to thank you to give us the opportunity to comment the exposure draft on amendments to IAS 32 and 39.

Please find enclosed the answer on this subject that ACTEO and MEDEF have prepared jointly.

Should you wish further comments or developments, please let us know and we would promptly answer to your requests.

Yours sincerely,

ACTEO	MEDEF
Philippe CROUZET	***Agnès LEPINAY***
Le Président	
P/O ***Jean KELLER***	
Le Délégué Permanent	Le Directeur des Affaires Economiques, Financières et Fiscales

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MEDEF

Exposure Draft of Proposed Amendments to IAS 32 & IAS 39

GENERAL COMMENTS

1. **Extensive use of fair value**

   As we have already expressed in the past, the extensive use of fair value as a measurement method raises, in our opinion, very critical issues. While we believe that fair value is an adequate valuation method when there is an intent to sell in the short-term on a liquid market, it should not in our opinion be so extensively used as requested in IAS 39. Because of this extensive use of fair value, financial information based on IAS 39 lacks, in our opinion, of usefulness (performance includes virtual gains and losses), relevance (market value may have nothing to do with the strategy and policy designed by management) and reliability (valuation models to be used when no market value is available cannot be the basis for a true and fair view).

   Therefore, we may agree to some of the proposals made by the Board, because they constitute an improvement to present IAS 39 and make its implementation easier, while we still strongly disagree on conceptual grounds.

2. **Hedging**

   We concur with EFRAG's objections and alternative proposals for the current hedge accounting requirements.

3. **Scope of the answer presented below**

   Banks and insurance companies face very specific and critical issues in the context of IAS 32 and IAS 39. These issues are not addressed below. They are however detailed and dealt with in the answer by the Conseil National de la Comptabilité that Acteo fully supports on that respect.

   Our comments and answers below appropriately reflect the position of those of our members who are involved in manufacturing, distribution and non-financial services.

IAS 32 - FINANCIAL INSTRUMENTS : DISCLOSURE AND PRESENTATION

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 ?

ACTEO'S ANSWER

No, we do not agree. Probabilities of different manners of settlement help to determine the substance of the instrument. Therefore, they should continue to be considered in determining at inception the substance of the instrument. Were the proposal by the Board implemented, substance over form would not be ensured.

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 ?

ACTEO'S ANSWER

Yes, we agree. This is consistent with the definitions of liability and equity, equity being a residual.

QUESTION 3 : CLASSIFICATION OF DERIVATIVES THAT RELATE TO AN ENTITY'S OWN SHARES (PARAGRAPHS 29C -- 29G)

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

ACTEO'S ANSWER

Yes, we do welcome this guidance as both useful and clear.

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.)

ACTEO'S ANSWER

Yes, we do. This would allow financial instruments to be dealt with consistently with other standards that usually address definitions, scope, recognition and measurement, and disclosures within a single standard. This would also eliminate any remaining inconsistency and any risk of useless repetition.

OTHER COMMENTS

Disclosure of the extent of use of valuation techniques and assumptions related thereto :

As we mentioned earlier in our general comments, the use of valuation models seriously impairs the transparency and the comparability of financial information.
We do not believe that disclosures can adequately cope with the lack of objectivity and transparency involved in such techniques. As is presently stated in IAS 1 § 12, "inappropriate accounting treatments are not rectified … by notes or explanatory materials".
Valuation models being highly sophisticated tools and investors and other users of financial statements no specialists in the field, we do not believe that disclosures can ever prove satisfactory. Moreover, "home-made" valuation models are part of entities' intellectual property and should therefore not be requested to be disclosed.

Credit insurance

We believe credit insurance should be clearly excluded from the scope of IAS 32 and IAS 39. We concur with the argument presented by the Conseil National de la Comptabilité.

IAS 39 - FINANCIAL INSTRUMENTS : RECOGNITION AND MEASUREMENT

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 ?

ACTEO'S ANSWER

Yes, we agree. This change should make things easier for both parties involved in the transaction, as explained in the basis for conclusions § C10 – C15.

QUESTION 2 : DERECOGNITION: CONTINUING INVOLVEMENT APPROACH(PARAGRAPHS 35-57)

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 ?

ACTEO'S ANSWER

We agree with the proposed approach, but we believe there is a need for further analysis and developments.

In comparison to IAS 39 present derecognition requirements, the proposed continuing involvement approach sounds right. We welcome the following features :

- criteria gain in objectivity,
- the approach should lead to a more reliable presentation of assets and liabilities, thanks to the partial derecognition features.

However, the proposed approach calls for further developments :

- The Board should come with a conceptual definition of the continuing involvement that would be consistent with the principle-based approach to international standards and that could be referred to in any situation;

- As proposed, recognition and measurement of assets and liabilities are too closely related to the form of the agreement which has lead to partial recognition, and hence may result in assets and liabilities that are not consistent with the definitions of the framework or that are not measured in accordance with present accounting standard requirements. There are indeed different natures of transactions that result in derecognition issues: derecognition can be originated in either a partial sale (the remaining asset is of the same nature as what we had before) or a 100% sale backed-up by a cash deposit or an obligation to repayment, or any combination of the above (the transaction may then alter the nature of the asset and/or create a liability).The proposed amendments do not reflect those differences;

- As written, the proposed text may conflict with SIC 12 requirements whereas full consistency should be ensured.

We therefore suggest that this approach be further investigated and criteria or principles be set up that will allow preparers to go for partial derecognition and nevertheless present assets and liabilities in accordance with IFRS conceptual and accounting requirements.

QUESTION 3 : DERECOGNITION: PASS-THROUGH ARRANGEMENTS (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 ?

ACTEO'S ANSWER

Yes, we agree, once consistency with SIC 12 be fully ensured (see answer to question 2).

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 ?

ACTEO'S ANSWER

We support § C58– C63 in the basis for conclusions and acknowledge that, as far as manufacturing, distribution and non-financial activities are concerned, fair value designation adequately solves practical problems originated in present IAS 39.

We however object to the irrevocable feature of the designation. In the course of life of the instrument, management should be entitled to appropriately move some instruments from held for trading to held to maturity and hence move from fair value to amortised cost (the cost basis would be the fair value of the instrument at the date when the change is carried out). Only then would the designation become irrevocable.

QUESTION 5 : FAIR VALUE MEASUREMENT CONSIDERATIONS (PARAGRAPHS 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 any suggestions for additional requirements or guidance ?

ACTEO'S ANSWER

The proposed guidance is clear.

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 ?

ACTEO'S ANSWER

We support the proposed treatment in principle, but recommend that the "risk premium" method described and recommended by the Conseil National de la Comptabilité be retained.

QUESTION 7 : IMPAIRMENT OF INVESTMENTS IN AVAILABLE-FOR-SALE FINANCIAL ASSETS (PARAGRAPHS 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 ?

ACTEO'S ANSWER

No, we do not agree. There is no conceptual basis to deal with available-for-sale financial assets differently from other assets. We understand that the Board's intent is to prevent subjective judgements to support impairment losses and reversals. We therefore suggest that reversals be limited in those instances when the facts that originated losses actually reverse.

QUESTION 8 : HEDGES OF FIRM COMMITMENTS (PARAGRAPHS 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 ?

ACTEO'S ANSWER

We agree with the proposed change.

QUESTION 9: BASIS ADJUSTMENTS

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 ?

ACTEO'S ANSWER

No, we do not agree. Hedging is a decision made by management in order to secure the amount of a forecast transaction. Therefore we believe that cumulative gains and losses do form part of the cost of acquisition. The Board argues that to recognise the effect of hedging as part of the cost of acquisition of the asset or liability would impair comparability since two same transactions, one hedged and the other not, would not result in equal assets or liabilities. In our opinion, proper accounting should reflect the decision made by management to go for a hedge. According to IAS 16, for example, the cost of acquisition includes the impact of any rebate or discount obtained by management. Hence two companies may buy the same piece of equipment and not record the same amount of asset, when one obtains a rebate and the other does not bother to negotiate. Hedging, in our opinion, should be viewed as part of the management of the acquisition.

We also disagree for practical reasons since the proposed treatment would result in burdensome and costly follow-up procedures for the bases of accounting of assets and liabilities that, at time of inception, have been subject to hedging. As far as a fixed asset is concerned, for example, combining over twenty years the effects of the component approach, of the annual review of residual value and amortisation rate, and of the reversal of gains and losses originated in hedged forecast transactions would undoubtedly require very costly information systems and procedures.

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 (ie that prior derecognition transactions should not be grandfathered) ?

Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied ?

ACTEO'S ANSWER

Yes, we agree. However, we suggest that this retrospective treatment be subject to an "undue cost or effort" exemption.

OTHER COMMENTS

REVIEW OF THE METHOD FOR ASSESSING THE EFFECTIVENESS OF HEDGES OF FUTURE FLOWS

Paragraph 147 of the standard states that valuation methods for the hedge effectiveness depend on the risk management strategy. This paragraph indicates that if the critical terms of the hedging instrument and of the hedged item are identical, the changes in the fair value and in the cash flows attributable to the risk being hedged offset fully, at the time the hedge entered into and until completion. Paragraph 151 outlines with an example the notion of identity of critical terms. Unfortunately the example is too simplistic and reality is often different. It appears essential to extend the terms of the standard to cope with the reality facing companies for hedge of future transactions.

Companies want the two following methods for the assessment of the hedge effectiveness (allowing to simplify the set-up of hedge accounting) to be included in the IAS39 standard :

- The short-cut method which allows to conclude that an interest rate swap with critical terms identical to the hedged debt instrument (maturity, nominal, currency – sub-jacent) may be considered as an effective hedge which does not require any arithmetic calculation, and so the accounting can be simplified ;

- the method of « critical terms identity » allowing to prove the effectiveness of a hedge instrument by ensuring that the critical terms of a hedge and the hedged item are consistent throughout the duration of the hedge- without having to record any ineffectiveness.

The following example will explain the second method.

Budget hedged in currencies

The transaction hedged in this case is a series of future forecasted flows for a specified time period (and not at a given date) and for which we are aware that timing may involve some uncertainty within a range.

While we feel it is important to be able to prove the effectiveness of any hedge at each closure date based on the criteria indicated in paragraph 146, it may be quite heavy to set up a follow-up procedure for the part which may possibly be ineffective for each hedged item. This will require considerable investment, particularly in terms of information systems, while the hedge relation is clearly established when at the inception of the hedge, and regularly until completion and that the critical terms of the hedge instrument and of the sub-jacent remain identical.

Examples with figures :

Example

The trend as of march 31 N+1 is as follows :

	Amount in FC	Average payment date
Actual operations - Q1	-450	15/03/N+1
Revised budget - Q2	-550	15/06/N+1
Revised budget - Q3	-600	15/09/N+1
Revised budget - Q4	-700	15/12/N+1
	-2300	

Hedge portfolio has changed as follows :

	Amount in FC	Maturity date	Forward rate (1 FC = xx LC)	
contract #1 utilized	450		0,8708	=> in P&L
contract #1 - roll-forward	50	15/04/N+1	0,8711	=> roll-forward using the initial forward rate
contract #2	600	15/06/N+1	0,8736	
contract #3	600	15/09/N+1	0,8766	
contract #4	200	15/12/N+1	0,8799	
	1900	- 450 = 1450		
	83%	covered		

Budget exchange variance

Quarterly budget in FC	Budget covered in FC	Average payment date	Forward rate estimated as of 31/03/N+1	Initial forward rate	MtM Base forward
-550	-550	15/06/N+1	0,8652	0,8736	4,62
-600	-600	15/09/N+1	0,8656	0,8766	6,6
-700	-300	15/12/N+1	0,8673	0,8799	3,78
-1850	-1450				15

MtM value of cash flow hedge contract

Amount in DEV	Maturity date	Forward rate estimated as of 31/03/N+1	Initial forward rate	MtM Base forward
50	15/04/N+1	0,8599	0,8711	-0,56
600	15/06/N+1	0,8652	0,8736	-5,04
600	15/09/N+1	0,8656	0,8766	-6,6
200	15/12/N+1	0,8673	0,8799	-2,52
1450				-14,72

Effectiveness measurement

	Quarterly Hedge contracts value	Quaterly Budget variance	Quarterly %	Total hedge contracts value	Total budget variance	Total %
15/04/N+1	-0,56	0		-0,56	0	
15/06/N+1	-5,04	4,62	109%	-5,6	4,62	121%
15/09/N+1	-6,6	6,6	100%	-12,2	11,22	109%
15/12/N+1	-2,52	3,78	67%	-14,72	15	98%

Example

The entity determines its needs in foreign currency (FC) in September N
The entity has communicated its quarterly needs as follows :

	Amount in FC	Average payment date
Budgeted operations - Q1	-500	15/03/N+1
Budgeted operations - Q2	-600	15/06/N+1
Budgeted operations - Q3	-600	15/09/N+1
Budgeted operations - Q4	-600	15/12/N+1
	-2300	

Contracts set up for the entity (forward contracts)

	Amount in FC	Maturity date	Forward rate (1 FC = xx LC)
contract #1	500	15/03/N+1	0,8708 (= forward rate contracted in september Y)
contract #2	600	15/06/N+1	0,8736
contract #3	600	15/09/N+1	0,8766
contract #4	200	15/12/N+1	0,8799
	1900		
	83%	covered	

At the closing date (12/31/N), the effectiveness measurement on cash flow hedges wil be done as followed:

The budget is revised by the entity :
No change in the total year amount
No change in the split between quarters

Budget exchange variance

Total budget in FC	Budget covered in FC	Average payment date	Forward rate estimated as of 31/12/N	Initial forward rate	MtM Base forward
-500	-500	15/03/N+1	0,8682	0,8708	1,3
-600	-600	15/06/N+1	0,8694	0,8736	2,52
-600	-600	15/09/N+1	0,8711	0,8766	3,3
-600	-200	15/12/N+1	0,8736	0,8799	1,26
-2300	-1900				8,38

MtM value of cash flow hedge contract

Amount in DEV	Maturity date	Forward rate estimated as of 31/12/N	Initial forward rate	MtM Base forward
500	15/03/N+1	0,8682	0,8708	-1,3
600	15/06/N+1	0,8694	0,8736	-2,52
600	15/09/N+1	0,8711	0,8766	-3,3
200	15/12/N+1	0,8736	0,8799	-1,26
1900				-8,38

Effectiveness measurement

	Quarterly Hedge contracts value	Quaterly Budget variance	Quarterly %	Total hedge contracts value	Total budget variance	Total %
15/03/N+1	-1,3	1,3	100%	-1,3	1,3	100%
15/06/N+1	-2,52	2,52	100%	-3,82	3,82	100%
15/09/N+1	-3,3	3,3	100%	-7,12	7,12	100%
15/12/N+1	-1,26	1,26	100%	-8,38	8,38	100%

Example

The trend as of june 30th N+1 is as follows :

	Amount in FC	Average payment date
Actual operations - Q1	-450	15/03/N+1
Actual operations - Q2	-490	15/06/N+1
Revised budget - Q3	-650	15/09/N+1
Revised budget - Q4	-650	15/12/N+1
	-2240	

Hedge portfolio has changed as follows :

	Amount in FC	Maturity date	Forward rate (1 FC = xx LC)
contract #1 utilized	450		0,8708 in P&L
contract #1b - utilized	50	15/04/N+1	0,8711 in P&L
contract #2 utilized	440	15/06/N+1	0,8736 => in P&L
contract #2 - roll-forwarc	160	15/07/N+1	0,8699 => roll-forward using the initial forward rate
contract #3	600	15/09/N+1	0,8766
contract #4	200	15/12/N+1	0,8799
	1900	- 940 = 960	
	85%	covered	

Budget exchange variance

Quarterly budget in FC	Budget covered in FC	Average payment date	Forward rate estimated as of 30/06/N+1	Initial forward rate	MtM Base forward
-650	-650	15/09/N+1	0,8602	0,8766	10,66
-650	-310	15/12/N+1	0,8611	0,8799	5,828
-1300	-960				16,488

MtM value of cash flow hedge contract

Amount in DEV	Maturity date	Forward rate estimated as of 30/06/N+1	Initial forward rate	MtM Base forward
160	15/07/N+1	0,8581	0,8699	-1,888
600	15/09/N+1	0,8602	0,8766	-9,84
200	15/12/N+1	0,8611	0,8799	-3,76
960				-15,488

Effectiveness measurement

	Quarterly Hedge contracts value	Quaterly Budget variance	Quarterly %	Total hedge contracts value	Total budget variance	Total %
15/07/N+1	-1,888	0	0%	-1,888		
15/09/N+1	-9,84	10,66	92%	-11,728	10,66	110%
15/12/N+1	-3,76	5,828	65%	-15,488	16,488	94%

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Example

The trend as of september 30th N+1 is as follows :

	Amount in FC	Average payment date
Actual operations - Q1	-450	15/03/N+1
Actual operations - Q2	-490	15/06/N+1
Actual operations - Q3	-700	15/09/N+1
Revised budget - Q4	-650	15/12/N+1
	-2290	

Hedge portfolio has changed as follows :

	Amount in FC	Maturity date	Forward rate (1 FC = xx LC)	
contract #1 utilized	450	15/03/N+1	0,8708	P&L
contract #1b - utilized	50	15/04/N+1	0,8711	P&L
contract #2 utilized	440	15/06/N+1	0,8736	P&L
contract #2b - utilized	160	15/07/N+1	0,8699	P&L
contract #3 utilized	540	15/09/N+1	0,8766	=>P&L
contract #3 - roll-forward	60	15/10/N+1	0,8761	=> roll-forward using the initial forward rate
contract #4	200	15/12/N+1	0,8799	
contract #5 - new	350	15/12/N+1	0,855	contracted 30/09/N+1
	2250	- 1640 = 610		
	98%	covered		

Budget exchange variance

Quarterly budget in FC	Budget covered in FC	Average payment date	Forward rate estimated as of 30/09/N+1	Initial forward rate	MtM Base forward
	-260	15/12/N+1	0,855	0,8799	6,474
-650	-350	15/12/N+1	0,855	0,855	0
-650	-610				6,474

MtM value of cash flow hedge contract

Amount in DEV	Maturity date	Forward rate estimated as of 30/09/N+1	Initial forward rate	MtM Base forward
60	15/10/N+1	0,857	0,8761	-1,146
200	15/12/N+1	0,855	0,8799	-4,98
350	15/12/N+1	0,855	0,855	0
610				-6,126

Effectiveness measurement

	Quarterly Hedge contracts value	Quaterly Budget variance	Quarterly %	Total hedge contracts value	Total budget variance	Total %
15/09/N+1	-1,146	0		-1,146		
15/12/N+1	-4,98	6,474	77%	-6,126	6,474	95%
15/12/N+1	0	0		-6,126	6,474	95%

Comments :

At the inception of the hedges

Draw up annual budgets for expected future flows by currencies : by currency, distinguish flows in and flows out, and indicate the period during which the flow is forecast (i.e. by quarter).

Set up hedge instruments : by currency, hedge the flows in and flows out by exchange rate contracts with distinct terms with at least one due-date minimum per quarter.

At the inception of the hedge, the « critical terms » of the hedging instrument (nominal, currency, maturity) and of the hedged item (total flow, currency, maturity) should be identical, and consequently any change in the fair value of the hedging instrument fully offsets the change in the fair value or in cash flow of the hedged item. Thus the company will conclude that the hedge is effective and no ineffectiveness should be recorded.

During the time period of the hedge

Update budgets every quarter for the remaining quarters to hedge. The provisional hedged budget is considered as a forward exchange contract, and valued as such.

Valuation of hedges remaining in portfolio(1).

The ratio « budget variance/real value of hedges » should be calculated every quarter.

If this ratio is less than 80% or more than 125%, the hedge is ineffective. The fair value of hedges is posted to the result in full. Excepting some restructuring of the hedge portfolio, it may no longer be considered as effective for the following closures.

If this ratio is between 80 and 125%, the cover is effective and no ineffectiveness should be posted to the result. Any gain or loss generated by the roll-forward of the hedge should be taken into account only at the time of the future flows realisations. The fair value of hedges is recognised in equity.

(1) If the hedging instrument is a purchased option and the option is in-the-money, the valuation method for assessing effectiveness can be applied.
If the option is out-of-the-money, it is not a case where the option hedges the risk and therefore, it can not be said that the hedge is ineffective.
Consequently, the change in fair value is recognised in equity.