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Le Président

JFL/PB/DC

N°85

Paris, 10 novembre 2009

Mr Stig ENEVOLDSEN
Chairman
EFRAG
35 Square de Meûs
B-100 BRUSSELS

Re : EFRAG's draft assessment of IFRS 9 "Financial Instruments"

Dear Stig,

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

First of all, we would like to underline that this near final draft of IFRS 9, upon which the EFRAG endorsement advice is based, has not been available for a time period sufficient enough to evaluate its effects (through field testing for instance).

Moreover, IFRS 9 is not a stand alone standard as it is presented by the IASB as the first step of a broader standard, with four more phases to go : impairment of financial assets, classification and measurement of financial liabilities, interaction with hedge accounting and the convergence process with US GAAP. Such incompleteness and temporary nature of IFRS 9 justify taking more time to assess the relevance of IFRS 9.

Our main concern is that this new standard on financial instruments fails to address the main accounting issues raised by the financial crisis and the requests made by the G20 and ECOFIN to "improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons".

Regarding technical aspects of IFRS 9, we note the IASB's decision regarding the following feature of the standard :

- the retention of a mixed measurement attribute model ;
- the promotion the business model as a key factor for classification of financial instruments (which implies, amongst other things, requiring reclassification in case of a change in the business model) ;

- the retention of the fair value option through profit and loss when it is relevant,

as highlighted in our comment letter to the IASB on its ED "Financial instruments : classification and measurement".

However, we still have the following concerns :

- regarding the classification categories :
  - The business model is not used to define the "fair value through profit and loss" category, thus the held for trading business model under current IAS 39 disappears. As expressed in the above-mentioned comment letter, we consider that fair value through profit and loss is an adequate measurement attribute only for instruments held for trading and assets contractually linked to liabilities at fair value through profit and loss.
  - The uncertainty related to illiquid instruments is not taken into account in the definition of fair value through profit and loss category. It will result in recognising in the income statement fair value gains or losses which are not realisable in the short term.
  - Those above-mentioned factors should lead to the creation of a third category (see our comment letter to ED financial instruments: classification and measurement), which should be reflective of business models varying from the other 2, in particular for instruments not actively traded in the short term.
  - The amortised cost category is too restrictive and, as a consequence of the prohibition to bifurcate embedded derivatives, will exclude the loan component of hybrid instruments from its most relevant measurement attribute.
- Regarding the relevant reporting of performance, the limitation of the fair value through other comprehensive income (OCI) category to equity instruments and the prohibition of recycling between OCI and profit & loss will result in a misrepresentation of the performance of entities in their income statement.

For all the reasons stated above, we disagree with EFRAG's draft conclusion on the assessment that IFRS 9 Financial Instruments satisfies the endorsement criteria. We consider, on balance, that the European Commission should not endorse IFRS 9 as currently stated.

Our detailed answer to your invitation to comment is provided in the appendix to this letter.

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

Yours sincerely,

Jean-Francois Lepetit

APPENDIX – DETAILLED COMMENTS

2. *EFRAG's initial assessment of IFRS 9 is that it meets the technical criteria for endorsement. In other words, it is not contrary to the true and fair principle and it meets the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out*

   a) *Do you agree with this assessment?*

   ☐ *Yes* ☒ *No*

The CNC considers that the European Commission should not endorse IFRS 9 for the following reasons :

Relevance :

We consider that the Board's decision to :

- Retain a mixed measurement model ;
- Remove the held-to-maturity category and its tainting rule in order to allow amortised cost for quoted debt instruments held for collecting cash flows
- Retain a fair value option in case of accounting mismatch ;
- Promote the business model as a key factor for classification and thus require reclassification between categories in case of a change in business model (we understand from this requirement that the reclassification allowed in October 2008 because of rare circumstances such as the financial crisis would also have been required by IFRS 9 if such circumstances led to a change in business model).

will result in the provision of relevant information.

However, we consider that the following elements impede the relevance of IFRS 9 :

1- Classification criteria :

   a. The IASB uses the business model in an unbalanced way, i.e.

      i. 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, decision-useful information consistent with the activities of the reporting entity.

    ii. Moreover, the removal of the "held-for-trading" business model has weakened the relevance of items being measured at fair value through profit and loss.

    iii. In order to develop a standard that really provides benefit, in terms of relevance, three categories should be clearly defined based on business models (see our proposal in the comment letter to ED financial instruments : classification and measurement).

b. Moreover, by allowing measurement at fair value through profit and loss of illiquid financial instruments or financial instruments which are held for a medium or long term time horizon, IFRS 9 will provide information to users which have proven to be irrelevant before and during the crisis, i.e. recognising in the income statement fair value gains or losses which are not realisable in short term. Hence, the IASB has not fully taken into account lessons to be learnt from the financial crisis...

c. The limitation of the amortised cost category to instruments with cash flows that are only payments of principal and interest will lead to inadequate information especially as the definition and examples provided on what payments of principal and interest means are rules-based and far too restrictive ; some financial instruments which do not exactly have these features and are currently recognised at amortised cost should still be eligible to this category if this is consistent with their business model. For instance,

    i. Excluding from amortised cost perpetual instruments (such as subordinated securities with no maturity dates) paying a market interest unless the issuer is not able to remain solvent immediately afterwards only because the additional interest does not accrue on deferred interest amounts is questionable; such effect would happen in rare cases and would probably not have a significant impact on the global return of the instrument. Moreover, this rule may prevent financial institutions from raising such perpetual funding, which include this particular feature because of regulator requirements ;

    ii. Rules related to contractually linked instruments that create concentrations of credit risks are too restrictive : the condition related to the weighted average credit risk of the underlying pool of financial instruments is arbitrary and could lead to removing from amortised cost instruments (e.g. mezzanine tranche) that were reclassified after the October 2008 amendment. Moreover, this seems contradicting with the definition of interest in IFRS 9 that includes payment in relation with credit risk. If the risk premium is appropriate, classification in the amortised cost category should be allowed if the business model is respected.

2- The relevant reporting of performance : the limitation of the fair value through other comprehensive income (OCI) to equity instruments and the prohibition of recycling between OCI and profit & loss, will prevent entities from using this category since it would result in a misrepresentation of their performance in the income statement. The CNC strongly believes that the income statement (instead of comprehensive income) is the most relevant indicator of performance. The recognition of dividends in profit & loss is therefore an improvement compared with the ED but it is not sufficient to provide a relevant and understandable reporting of performance (especially for the insurance industry). Income must be recognised (or recycled) in profit and loss according to principles consistent with the business models (which lead to three financial instrument categories). Moreover, the CNC regrets that the IASB did not deal with the impairment of equity instruments by taking into account investors' holding horizons and allow the reversal of impairment.

3- The removal of the embedded derivative requirements to bifurcate a hybrid instrument is not relevant since it does not 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). Hence, it will extend fair value through profit & loss to the loan components of hybrid instruments, which would meet amortised cost conditions.

As a consequence, we believe, overall, that IFRS 9 will not provide relevant information.

<u>Reliability :</u>

1- IFRS 9 removes the cost exception for unquoted equity instruments whose fair value is not reliable. Moreover, circumstances (given in the application guidance) under which cost can be representative of fair value will be rare in practice. Thus, information resulting from the fair valuation of such equity instruments will be subject to suspicion.

As a consequence, the CNC believes that IFRS 9 does not meet the criterion of reliability on this point.

Comparability :

The transition rules of IFRS 9 will not improve comparability of the information provided since :

- An entity will have to choose to adopt this IFRS between 2009 and 2013. Hence, the annual financial statements of entities applying IFRS will be difficult to compare for the next four years.
- Moreover, "if an entity adopts this IFRS for reporting periods beginning before 1 January 2011, the date of initial application can be any date between the issue of this IFRS and 31 December 2010". This will add another difficulty to compare financial statements even between entities adopting IFRS 9 during the same reporting period.
- IFRS 9 and IFRS 4 phase II will not have similar mandatory application dates. Hence, we consider that re-designation of financial assets should be allowed at the date of mandatory application of IFRS 4 phase II.

The option given to entities on classification of equity instruments measured at fair value through OCI instrument by instrument will also go against comparability. It would be more relevant to define clearly and positively three categories for financial assets based on business models (as proposed in our comment letter to the IASB's ED Financial instruments : classification and measurement) instead of creating a third category at fair value through OCI by option.

Therefore, the CNC considers that IFRS 9 does not meet the criterion of comparability of the information provided.

Understandability

In addition to the items identified in the relevance caption, several provisions of IFRS 9 will obscure understandability :

- The inconsistent treatment of financial assets and liabilities (which will remain within the scope of IAS 39 according to §2.1. but are nevertheless impacted by transition provisions according to §8.10 and 8.12).
- The prohibition to bifurcate embedded derivatives included in hybrid assets that will obscure information provided on their genuine effect while fair valuing host instruments that separately meet the business model and characteristics justifying a measurement at amortised cost.
- The recognition in profit and loss of variations of fair value of some financial assets not held for trading purpose (short term horizon) will not provide an understandable net income.

- The prohibition of recycling fair value variations (excluding dividends) of equity instruments measured at fair value through OCI will not provide an understandable reporting of performance in the income statement.

Therefore, the CNC considers that IFRS 9 does not meet the criterion of understandability.

b) *Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the amendment? If there are, what are those issues and why do you believe they are relevant to the evaluation?*

See question 4

2 EFRAG is also assessing the costs that will arise for preparers and for users on implementation of IFRS 9 in the EU, both on initial adoption and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete that assessment.

The results of the initial assessment are set out in paragraphs 8, 11, 15 and 23 of Appendix 3. To summarise, EFRAG's initial assessment of IFRS 9 is that:

(a) *For prepares, there may be significant year one costs arising from initial adoption of the Standard and not significant costs from transition and additional disclosure requirements; and moderate ongoing incremental costs.*

(b) *For users, application of IFRS 9 is likely to involve significant additional costs in year-one and, for some users, moderate ongoing incremental costs.*

Do you agree with this assessment?

☒ *Yes* ☐ *No*

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

We agree with EFRAG's assessment that there will be significant costs to users and preparers on initial adoption.

All the more since IAS 39 will be replaced in 4 more phases : impairment of assets, classification and measurement of financial liabilities, interaction with hedge accounting and the convergence process with US GAAP. Each of them is susceptible to call into question changes already applied, implementation costs will be repeated several times.

The increasing significant divergence between financial reporting and regulatory reporting will also involve incremental costs for the banking industry.

3 *EFRAG's initial assessment is that IFRS 9 will reduce complexity in the classification and measurement aspect of reporting financial instruments (see Appendix 3, paragraphs 17 and 19) and that the benefits to be derived from that are likely to exceed the costs involved (see Appendix 3, paragraph 24 and 25).*

Do you agree with this assessment?

☐ *Yes* ☒ *No*

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

While we agree that IFRS 9 will reduce complexity in the recognition of financial instruments, we believe that accounting for financial instruments and a fair representation of business model is by nature a complicated subject. It remains vital to give priority to the relevance of the accounting treatment of financial instruments instead of an oversimplification. Benefits in terms of relevance are negative, which impedes benefits arising from simplification. Moreover, as IFRS 9 will result in more complex illiquid instruments to be measured at fair value, the simplification of classification will be offset by more complexity in estimating the fair value of these instruments (level 3 of fair value hierarchy)

Overall, the CNC considers that significant implementation costs will not be outweighed by the limited benefits (see question 2) resulting from the application of IFRS 9.

4 *EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the amendment.*

Do you agree that there are no other factors?

☐ *Yes* ☒ *No*

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

First of all, we would like to underline that the urgent process followed by EFRAG raises significant concerns since :

- the draft endorsement advice is based on the near final draft of IFRS 9, which is not a public and final document,
- this near final draft has not been available for a time period sufficient enough to evaluate its effects.

Secondly, the CNC is particularly concerned by the piecemeal approach followed by the IASB which results in difficulties in the assessment of an unfinished standard :

- The relevance of the classification principle should be assessed by taking into account the interaction with phase III on hedging or IFRS 4 phase II for insurance contracts. To date, we note that no exposure drafts are available on these issues.
- The incompleteness of phase I is more problematical : the decision taken by the Board to exclude financial liabilities from the scope of IFRS 9 in the short term could create accounting inconsistencies between financial assets and financial liabilities and underline the fact that the quality of the IAS 39 revision may suffer from hasty decisions.

Moreover, this completeness issue will be impacted by the work plan for convergence on the financial instruments project between the IASB and the FASB. IFRS 9 could be significantly amended due to this convergence process even before its mandatory application on or after January 2013.

These concerns deserve more time to be devoted to them as part of the assessment of phase 1 of the IAS 39 revision. Moreover, the very significant changes proposed have not been subject to an appropriate preliminary effect study. Therefore, it does not seem reasonable to endorse such a significant project without having a perfect understanding of its consequences.

Thus we agree with the dissenting views expressed in the EFRAG's draft endorsement advice which outline these concerns.