

FASB Technical Director 401 Merritt 7, PO Box 5116 Norwalk, CT 06856-5116 US

Paris, Sept 30, 2010

Re: File Reference N° 1810-100: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Dear Sir or Madam,

- 1. MAZARS welcomes the opportunity to comment on the FASB Exposure Draft, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. This letter summarizes our main views on the Exposure Draft.
- 2. We support the Board's overall objective to improve the reporting for financial instruments and to pursue convergence with IFRS on this important area. However the FASB exposure draft raises strong concerns which are detailed below.

#### Measurement model

- 3. We disagree with the measurement model proposed in the Exposure Draft which does not provide the appropriate balance between amortized cost and fair value measurements and, therefore, does not meet the objectives of financial reporting in providing relevant and reliable information to users.
- 4. We understand that the proposed measurement model would result in a "full fair value" approach for financial institutions such as banks since they carry proportionally very few short term trade receivables / payables or liabilities linked to assets not measured at fair value. We strongly disagree with this outcome as we consider that a full fair value approach does not accurately picture the way financial institutions manage their activity, especially in the retail industry. Instead, we consider that amortized cost is the best measurement method for financial instruments managed for collection or payment of cash-flows, rather than primarily managed on a fair value basis. For these financial instruments, we believe that fair value information is more appropriately provided in the notes to the financial statements.





- 5. In contrast with FASB's proposal, we therefore support a mixed measurement model in line with IFRS 9 where classification is based on instrument characteristics and the entity's business model. We are convinced that both "amortized cost" and "fair value" measurement approaches are needed to reflect the way entities actually manage their financial instruments and to provide relevant information about financial performance.
- 6. We believe that the business model should be the driving principle defining the boundary between amortized cost and fair value. The instrument characteristics would represent a safeguard for a consistent application of the principle that certain instruments are unsuitable for management on a contractual cash-flow basis.
- 7. Moreover, we consider that industry specific provisions are pointless if the future standard on financial instruments relies on a robust principles-based approach taking into account the entity's business model.

#### Reclassification

- 8. We agree with the FASB's opinion stated in the paragraph 22 of the proposed guidance that an entity shall evaluate its business strategy for a financial instrument on the basis of how the entity manages its financial instruments rather than on its intent for an individual instrument.
- 9. Consistently, if an entity actually changes the manner in which it manages its financial instruments, reclassification should be required (not permitted) together with relevant disclosures.
- 10. We therefore disagree with the FASB's intention to preclude an entity from any kind of reclassification. We rather consider that precluding reclassification would increase the complexity and reduce transparency for users of financial statements since some financial instruments would not be classified in accordance with the way they are actually managed.
- 11. In this regard we agree with current IFRS 9 provisions.

#### Equity instruments held

12. We consider that presenting changes in fair value in net income for some equity portfolios may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments with long term objectives rather than primarily for short term increases in the value of the investment (focus on business model). We recommend that the FASB allows the use of "Available for sale" category for equity instruments when the business model of the entity shows that they are held for long term objectives. We are aware that this would imply dealing with the complex issue of equity impairment which needs to be improved. But the complexity of the issue should not impair the correct accounting representation of the entity's business model.



#### Embedded derivatives on the asset side

13. We agree with the proposal to remove current bifurcation requirements on the asset side since current guidance is too complex and ruled-based, thus giving rise to structuring opportunities We also consider that the boundary provided by IFRS 9 between amortized cost and fair value is not appropriate and should be amended to appropriately reflect the way entities manage their financial instruments (e.g. non recourse loans, vanilla mortgage loans paying CMS indexed interest rates due to local legal constraints). One starting point for improvement would be to establish principle-based bifurcation requirements that could, for instance, be inspired by IFRS 9 asset classification conditions.

#### Financial liabilities

- 14. We understand that the FASB's proposal results in measuring all financial liabilities at fair value except qualifying financial liabilities in situation of accounting mismatch. We strongly disagree with this approach for the reasons detailed below.
- 15. A large majority of entities issue financial liabilities primarily to fund their core operational activities. Consequently we consider that amortized cost is generally the best measurement method for financial liabilities. We believe that fair value measurement should be required when the entity manages its financial liabilities on a fair value basis (for example within a trading activity) or offered as an option in situations of accounting mismatch.
- 16. Even structured liabilities are in most cases issued within a business model of contractual cash-flow payments, the structured component being hedged with derivatives. We consider that the best way to address this situation is to maintain the bifurcation of embedded derivatives for financial liabilities.
- 17. Besides, we are also convinced that changes in the credit risk component of a financial liability should not impact net income, except when the financial liability is held for trading. Including changes in own credit risk in the measurement of a financial liability on the face of the statement of financial position:
  - Results in a counter-intuitive impact on comprehensive income as it would lead an entity experiencing a deterioration of its financial situation to recognize a gain in comprehensive income.
  - Does not in our view provide relevant information to financial statement users as these changes in value are rarely realized in practice and therefore do not predict reliably the entity's future cash-flows.
- 18. Therefore we recommend that the Board excludes changes in an entity's own credit standing from the subsequent measurement of financial liabilities measured at fair value. We are convinced that this approach, generally called "frozen credit spread", combined with relevant disclosure requirements would provide more relevant information to users of financial statements.



- 19. However, taking into account the limited support for the "frozen credit spread" approach, we consider that presenting the effect of own credit risk in other comprehensive income, and requiring any realized gain or loss to be recognized in net income, similarly to any other financial liability in order to ensure consistency, is probably the best way forward.
- 20. For all these reasons, we consider that the IASB's proposal on financial liabilities is a better starting point for a converged approach than the FASB's proposal.

## Core deposit liabilities

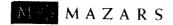
- 21. We disagree with the proposed measurement approach to core deposit liabilities since it introduces another measurement basis and raises operational issues, especially in determining the discount factor ("the difference between the alternative funds rate and the all-in-cost-to-service rate").
- 22. Moreover the proposed approach would result in attributing some value to the customer relationship resulting in the recognition of an internally generated intangible asset. This is not consistent with the treatment of other internally generated intangible assets.
- 23. However, we note that the FASB acknowledges that portion of core deposit liabilities constitutes permanent core funding with implied economic maturity that should be taken into account for accounting purposes. The implied maturity of core deposit is evidenced in the way banks actually manage their economic exposures and we recommend both Boards to take this economic reality into account in their hedge accounting proposals.

## Short-term trade receivables and payables

- 24. We support the proposed option to measure short-term trade receivables and payables at amortized cost as most entities hold this kind of instruments for the collection/payment of contractual cash-flows.
- 25. However the difference between fair value and amortized cost for vanilla short-term receivables and payables is generally not significant. In our opinion, the critical issue is on medium/long term instruments hold within a cash-flow collection business model for which fair value measurement does not provide the most relevant information.

## Presentation in the statement of financial position and disclosures

26. FASB's proposal would lead to present on certain occasions two measurements attributes for a single instrument on the face of the statement of financial position, namely fair value and amortized cost. We strongly disagree with this proposal which adds both complexity for financial statement users and operational costs for preparers.



- 27. We are convinced that a robust and operational classification approach relying on the entity's business model is better materialized by presenting the relevant measurement attribute on the face of the statement of financial position, while the other one is disclosed in the notes to financial statements.
- 28. When fair value is disclosed in the notes rather than on the face of the statement of financial position, the Board should keep in mind that disclosing changes in fair value in addition to fair value at closing date requires significant changes in internal information systems. Therefore from a cost-benefit view point, we believe that the Board should require entities to disclose in notes the fair value of financial instruments that are measured at amortized cost on the face of the statement of financial position, and not their changes in fair value. The disclosures in IFRS 7 seem satisfactory in this regard.

### **Impairment**

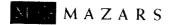
- 29. We welcome the FASB's intention to develop an impairment model based on an expected loss approach.
- 30. The FASB's proposed guidance contains in our view two main advantages compared to the one elaborated by the IASB in its exposure draft "Financial instruments: Amortized cost and impairment":
  - The recognition of impairment losses is not included into the effective interest rate mechanism. The proposed "decoupling approach" appears more operational.
  - It ensures that the cumulative loss recognized at the end of a period regarding the credit risk of a loan portfolio at least equals the amount of the cumulative loss incurred to date.
- 31. However, the impairment model proposed by the FASB raises the following concerns:
  - We believe that future events and economic conditions should be taken into account as long as they are expected to occur within a time frame consistent with the maturity of the financial assets considered.
  - We disagree with the "up front" recognition (in some cases a "day 2 loss") in net income of all credit losses expected over the life of the financial asset. We believe the expected credit losses should be recognized over the life of the instrument to match the timing of revenue recognition on financial instruments.
  - The proposed method assumes that the entity has a comprehensive view of the timing of its cash-flows which is often not the case for instruments included in "good book" portfolios.
- 32. Overall, we think that the FASB should consider an impairment model where an expected loss model would be a complement to the current incurred loss model. We consider that information on the statement of comprehensive income about actual losses is key to users of financial statements. We thus propose an impairment model that would replicate the way financial institutions actually manage their loans, distinguishing:
  - A "good book" comprised of performing loans on which an expected loss model would be retained.
  - A "bad book" on which an impairment process similar to the current incurred loss model would be applied.



- 33. Combining these two approaches would ensure that the allowance account is large enough to fully cover incurred losses.
- 34. We understand that the IASB is currently considering such an approach and encourage both Boards to fully consider this proposal that is in line with actual practice.
- 35. We acknowledge that estimating expected losses requires judgment. Therefore we consider that the approach implemented by the entity should in any case include a back testing mechanism and a periodic analysis of the allowance account variations.

#### Hedging

- 36. We welcome the FASB's general approach to loosen effectiveness assessment while requiring ineffectiveness to be recognized in net income. We agree with the removal of the [80%:125%] bucket and the Board's proposal to lower the effectiveness requirements from "highly effective" to "reasonably effective".
- 37. We also support the Board's efforts to simplify effectiveness assessment:
  - A qualitative assessment shall be performed to assess hedge effectiveness; a quantitative assessment is mandatory only if qualitative assessment cannot establish that the hedge will be reasonably effective.
  - The assessment of hedge effectiveness shall be performed at the hedge inception; a subsequent assessment is required only if changes if circumstances indicate that the hedging relationship may no longer be reasonably effective.
- 38. We note that the FASB removed the short cut and critical-term-match methods to measure effectiveness. Should the Board confirm this decision, we would recommend retaining practical expedients to measure ineffectiveness in the case of noncomplex hedging relationships where effectiveness is clearly evidenced in order to limit the burden associated to the preparation and follow up of a comprehensive documentation.
- 39. We do not support the FASB's proposal to recognize ineffectiveness on cash-flow hedge in case of under hedging as it may lead to the recognition of gains or losses on transactions that do not exist yet (i.e. highly probable transactions).
- 40. We also disagree with the proposed guidance preventing dedesignation of the hedging relationship once it has been established unless the hedge is no longer expected to be reasonably effective or the hedging instrument is sold, terminated or exercised. This approach is not consistent with the dynamic hedging strategy widely implemented by entities and can be easily circumvented as recognized by the FASB in paragraph BC 222.
- 41. Finally, we regret that the FASB did not take the opportunity of this Exposure Draft to address issues related to portion hedging on non-financial instruments. We encourage both Boards to work on this topic, and especially to consider the possibility of hedging explicit indexation embedded in non-financial instruments.



## Scope

42. We disagree with the amendment of the scope of instruments measured under the equity method. We believe that the Exposure Draft on financial instruments is not the proper place to address equity method accounting and that this issue should be included in a comprehensive project on accounting for investments in associates. Additionally, we do not consider that proposed requirements would be operational or would provide the most relevant information. Determining whether an investment is related to the investor's consolidated operations is a matter a judgment and does not stand up to today's business environment and the complex structure of groups. For instance, it may be difficult to agree on whether the operations of an insurance or IT company are sufficiently related to the operations of a banking group.

#### Effective date

- 43. We believe that the proposed guidance requires much IT and organizational developments. As such, we believe that the FASB should allow a reasonable time period for entities to implement the proposed update. We would suggest to allow a 3-year time period after the issuance of the final standard with an exemption period for smaller nonpublic entities.
- 44. However, we believe that the exemption period for nonpublic entities that report less than \$1 billion of assets in their statement of financial position shall be limited to 1 year. We consider that 1 year constitutes a sufficient time period to enable smaller entities to benefit from the learning curve of larger groups to adapt their internal organization. Additionally, establishing a 4-year exemption period would lead to the coexistence of two different standards for an extending period of time which may create confusion among investors.

## IFRS 9 is a better basis for a converged standard

45. We encourage both Boards to pursue their work on a future converged standard for financial instruments. However, we strongly believe that convergence should not be achieved at the cost of standard quality. On this basis, and for all the reasons explained above, we are convinced that IFRS 9 provides a much better basis for a converged standard than the FASB Exposure Draft.

Do not hesitate to contact us should you want to discuss any aspect of our comments.

Best regards,

Michel Barbet-Massin

Head of Financial Reporting Technical Support



# **Appendix**

The table below links questions of the FASB Exposure Draft with the appropriate paragraph in our letter.

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## M A Z A R S

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