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6 October 2004

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

**Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts and Credit Insurance**

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (the Board's) Exposure Draft - *Financial Guarantee Contracts and Credit Insurance* (the proposed amendment).

We support the proposed approach in the Exposure Draft. In particular, we agree that the legal form of a financial guarantee contract should not affect its accounting treatment, and strongly support the proposal to bring financial guarantee contracts within the scope of IAS 39 and remove them from the scope of IFRS 4. We believe that including these contracts in IAS 39 will provide more robust measurement guidance than IFRS 4 in the interim before the completion of phase II of the Board's project on insurance contracts. We suggest that the Board review this position once phase II of the insurance contracts project is finalised.

We note that some of the draft changes outlined in the proposed amendment do not amount to changes of substance (in terms of recognition and measurement) but rather represent an attempt to present guidance already within IAS 39 in a more systematic and logical fashion. This comment applies, for example, to the proposed changes to paragraphs dealing with the treatment of loan commitments. We support these changes.

We appreciate the opportunity to provide our comments. If you have any questions concerning our comments, please contact Ken Wild in London at (020) 7007 0907.

Sincerely, \

Deloitte Touche Tohmatsu

**APPENDIX – Responses to Questions in Exposure Draft**

***Question 1 – Form of contract***

*The Exposure Draft deals with contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (financial guarantee contracts). These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Under the proposals in the Exposure Draft the legal form of such contracts would not affect their accounting treatment (see paragraphs BC2 and BC3).*

*Do you agree that the legal form of such contracts should not affect their accounting treatment?*

*If not, what differences in legal form justify differences in accounting treatments? Please be specific about the nature of the differences and explain clearly how they influence the selection of appropriate accounting requirements.*

We agree with the principle that the legal form of financial guarantee contracts (as defined in the proposed amendment) should not affect their accounting treatment. We support this principle since it is consistent with ensuring that IFRS is a robust, principles based accounting regime, under which differences in accounting treatment are driven by differences in the substance of economic arrangements rather than legal form. In a similar vein we support the Board's view (as expressed in paragraph BC 26c) of the Exposure Draft) that differences based on the nature of the parties issuing the contract would also not be appropriate.

We note that this in itself does not represent a fundamental change to the Board's approach. Indeed paragraph AG4A of IAS 39 (prior to the impact of the proposed amendment) included a statement to the effect that financial guarantee contracts may take various legal forms, with their accounting treatment not depending on this legal form. A similar sentiment was expressed in IG Example 1.11 in the *Guidance on Implementing IFRS 4* (before the impact of the proposed amendment).

***Question 2 – Scope***

*The Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 (see paragraph 2 of IAS 39 and paragraph 4 of IFRS 4), and defines a financial guarantee contract as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument" (see paragraph 9 of IAS 39).*

*Is the proposed scope appropriate?*

*If not, what changes do you propose, and why?*

We note that the definition of a financial guarantee contract (as included in the proposed amendment within the draft paragraph 9 of IAS 39) is consistent with the notion already enshrined in the revised IAS 39 issued in December 2003 (previously paragraph 2f)).

We support the proposal to include such contracts in the scope of IAS 39 rather than, as is currently the case, within the scope of IFRS 4. Whilst we acknowledge that such contracts may meet the definition of insurance contracts within IFRS 4, we believe that including them in the scope of IAS 39 would have several important advantages:

- We believe that the recognition of a financial liability equal to the fair value of the contract at inception (as will be required under paragraph 43 of IAS 39 if the contracts are within the scope of that standard) is the appropriate accounting for a financial guarantee contract. Under the current version of IFRS 4 (prior to the impact of the proposed amendments) the issuer is able to continue using its existing accounting policies, provided these meet the very limited criteria of paragraphs 14-20 of IFRS 4, and would not recognise a liability at inception. This point is acknowledged in the current wording of Example 1.11 of *Guidance on Implementing IFRS 4* (prior to the changes included in the proposed amendment).

- We believe that the use of IAS 37 provides a robust test of when a liability should be recognised, whilst under IFRS 4 as it currently stands there is a lack of a comparably robust test. To the extent that the issuer carries out a liability adequacy test meeting the minimum requirements set out in paragraph 16 of IFRS 4, the issuer is not required to make use of IAS 37 in determining whether a further liability should be recognised. We are not convinced that the minimum requirements pertaining to liability adequacy tests are robust enough to be equivalent to the requirements of IAS 37. Therefore, we prefer that IAS 37 apply as proposed in the Exposure Draft.

- Paragraphs 45-46 of IAS 37 require provisions to be discounted where the effect is material. We believe this is the right principle. In contrast, paragraph BC 101 of IFRS 4 states that the Standard does not specify *"whether or how the cash flows are discounted to reflect the time value of money or adjusted for risk and uncertainty"*. Paragraph BC 126 states that despite the Board's view that *"discounting of insurance liabilities results in financial statements that are more relevant and reliable*" IFRS 4 does not (pending outcome of phase II of the insurance project) require discounting of such liabilities and merely prohibits a change from an accounting policy that involves discounting to one that does not involve discounting (paragraph 25a) of IFRS 4). Thus, to the extent that an entity's current policy is one of not discounting the liabilities arising on issue of financial guarantee contracts in the absence of the effect of the proposed amendment the entity could continue to maintain such a policy under IFRS.

- We believe the proposed amendment would improve the consistency of application of accounting requirements in respect of financial guarantee contracts.

As noted in our comment letter on ED 5 *Insurance Contracts,* we did not agree with the approach taken by that Exposure Draft. Consequently, we do not believe that the requirements of IFRS 4 provide a sufficiently robust framework for financial reporting in respect of insurance contracts. We believe that in the absence of the proposed scope change to IAS 39 and IFRS 4 as included in the proposed amendment these deficiencies in the requirements of IFRS 4 would not result in the most desirable accounting for financial guarantee contracts from the perspective of the issuer.

*Question 3 – Subsequent measurement*

*The Exposure Draft proposes that financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party, should be measured subsequently at the higher of:*

*(a) the amount recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and*
*(b) the amount initially recognised (ie fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue (see paragraph 47(c) of IAS 39).*

*Is this proposal appropriate? If not, what changes do you propose, and why?*

We believe that the proposed basis for the subsequent measurement of financial guarantee contracts is appropriate. However, we note that the wording within paragraph IN3a) of the Exposure Draft could potentially be seen as misleading. The paragraph, whilst noting that financial guarantee contracts are measured initially at fair value, currently includes a statement that "if the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary." We note that in the case of many financial guarantee contracts the premium is paid over time, and since in accordance with paragraph 43 of the Standard, the financial guarantee contract must be recognised initially at its fair value, that fair value includes also any premium receivable. In view of this we suggest it may be desirable to extend the above statement to include explicitly any premium receivable and thereby alter the wording in IN3a) in order to avoid any potential confusion.

For financial guarantee contracts where the premium is receivable over time, it is not clear whether the premium and the guarantee should continue to be viewed as essentially one contract and how in that case revenue should be recognised and presented in the income statement.

The above point is linked to the broader conceptual question of whether a financial guarantee contract in substance involves two accounting elements: a service of making payments to reimburse the holder for a loss it incurs if a specified debtor were to default for which revenue should be recognised over the period of the guarantee, and separately a provision for any such loss under IAS 37. The Board may wish to consider, either in the context of this Exposure Draft or in the context of another project such as, perhaps, Phase II of the insurance project, the issue of whether a financial guarantee contract should be recognised and measured on a net or gross basis. To demonstrate this, consider the example of an entity that issues a financial guarantee contract under which it agrees to make payments to reimburse for non-payment of an amount of 100 due in four equal annual instalments, in return receiving up front a premium of 4. At the end of the first year assume that the payment of the second instalment of 25 is no longer probable. At the end of year one under the requirements of the Exposure Draft the financial guarantee contract is remeasured to 25. The remeasurement amount of 21 however could be seen as either gross or net. On a gross basis the entity would recognise a loss of 22 in respect of the recognition of a liability and income of 1 in respect of the provision of the service of standing ready to reimburse the counterparty for non-payment of the debtor.

Regardless of the above considerations given that some financial guarantee contracts meet the definition of insurance contracts we note that the Board should revisit the model proposed in the Exposure Draft in light of the conclusions reached upon finalising phase II of the insurance contracts project.

***Question 4 – Effective date and transition***

*The proposals would apply to periods beginning on or after 1 January 2006, with earlier application encouraged (see paragraph BC27). The proposals would be applied retrospectively.*

*Are the proposed effective date and transition appropriate? If not, what do you propose, and why?*

As noted in our responses to Questions 2 and 3 we support the proposed change with respect to the accounting for financial guarantee contracts. Therefore, we would support the earliest possible effective date for the proposed amendment.

In view of the Board's commitment to a 'stable platform' of standards for use in 2005, we agree that the earliest possible effective date is for annual periods beginning on or after 1 January 2006. We strongly support the allowance for entities to implement the requirements early. This will be particularly relevant to current IFRS reporters who can early adopt this amendment in order to ensure they continue to account for financial guarantee contracts in accordance with IAS 39. For first time adopters that wish to adopt this amendment early, they will also benefit from applying what we regard as improved accounting guidance in respect of financial guarantee contracts.

***Question 5 – Other comments***

*Do you have any other comments on the proposals?*

We note that in both IN11 and BC4 of the proposed amendment specific reference is made to the fact that the Exposure Draft does not deal with the treatment of financial guarantee contracts from the perspective of the holder. We understand that the aim of the proposed amendment was to clarify what the Board believes to be the appropriate accounting for such contracts by the issuer. We understand that, if a credit guarantee contract meets neither the definition of a financial guarantee contract under the proposed amendment to IAS 39 nor the definition of an insurance contract under IFRS 4, the instrument is to be measured as a derivative under IAS 39 both by the holder and the issuer. However, we believe it would be useful to have similar clarity in terms of the treatment by the holder for a contract that is not a derivative, and meets the definition of a financial guarantee contract.