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Mr Robert Garnett
Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London
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Email: ifric@iasb.org

16 June 2008

Dear Mr Garnett,

Tentative agenda decision: IAS 39 Financial Instruments: Recognition and Measurement - Application of the Effective Interest Rate Method

Deloitte Touche Tohmatsu is pleased to respond to the International Financial Reporting Interpretations Committee's (the IFRIC's) publication in the May 2008 *IFRIC Update* of the tentative decision not to take onto the IFRIC's agenda a request for an interpretation on the application of the effective interest rate (EIR) method.

In summary, we believe the tentative agenda decision wording does not provide sufficient clarity and that additional interpretive guidance is needed. We believe there are three important interpretative issues that need to be addressed:

(i) how to apply the effective interest rate to debt instruments with a market-based reset;
(ii) when should an entity apply AG7 compared to AG8; and
(iii) for inflation linked debt, is it possible to analogise with IAS 29 in the case when an entity is not applying that standard.

The application of the EIR is critical in determining the balance sheet carrying amount and the impact on profit or loss for debt instruments held at amortised cost, as well as the income recognition for those debt instruments classified as available-for-sale. The EIR has widespread application for both vanilla and complex debt instruments, yet the standard is not clear as to how the EIR method applies for instruments with variable cash flows. As illustrated in the observer notes for the May 2008 IFRIC meeting (Agenda Paper 6), the resulting divergence in practice has the potential to result in significantly different financial results depending upon the method of application used. This could result in not only a lack of comparability amongst entities but also different applications within an entity. We believe the tentative agenda decision does not provide the necessary clarity and, therefore, further work is needed to address the following three issues.

(i) Application of the EIR to debt instruments with a market-based reset

The definition of the EIR method in IAS 39.9 makes clear that an entity must project expected cash flows and discount them back at a single rate to equal the carrying amount. In the case of vanilla floating rate debt, say issued at par with no transaction costs, with interest linked to market interest rates, say LIBOR, this would require an entity to project cash flows and determine an EIR which could theoretically be different to the interest flows received/paid in cash during the period. Such a technique may result in a carrying amount different to par immediately following an interest payment date. For instance, in a situation where a liability has a upward sloping interest rate curve, discounting the estimated cash flows using a single EIR (as opposed to using the applicable spot interest rate on the interest yield curve to discount each cash flow) may result in the carrying amount of the liability exceeding its par value subsequent to the interest payment date, even absent any changes in interest rates or other assumptions. IAS 39.AG7 acknowledges that such a difference could exist, as it states:

> "If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, *re-estimating the future interest payments normally has no significant effect* on the carrying amount of the asset or liability." *[emphasis added]*

We note, however, that some believe as long as an instrument is issued or acquired at par with no transaction costs where the interest flows are linked to a market interest rate, then the carrying value immediately following payment/receipt of the interest will *always* result in the carrying value being equal to par (i.e. there is no need to project future cash flows as part of the application of the EIR method). This argument is based on an extract of IAS 39.AG6:

> "For example, *if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates*. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates." *[emphasis added]*

We note that the tentative agenda decision makes reference to AG6 and AG7 but fails to address the potential conflict between these two paragraphs. Consistent with the staff analysis in the observer notes for the May 2008 IFRIC meeting (Agenda Paper 6), we suggest the IFRIC confirm that IAS 39 does not require a single rate to be used to discount estimated future cash flows for instruments whose changes in cash flows reflect movements in 'market rates of interest' (see paragraphs 19-21 of the observer notes). That is, each of the estimated cash flows may be discounted using the applicable spot rates on the interest yield curve. If the IFRIC believe paragraphs AG6 and AG7 are not clear, or potentially in conflict, we suggest that this issue be referred to the Board for clarification and, if that clarification is forthcoming, then the Board consider making the standard clear in the next annual improvements process.

(ii) IAS 39.AG7 versus AG8

IAS 39.AG7 and AG8 provide two different measurement techniques, the former resulting in the reassessment of expected cash flows and a discounting using an *updated* EIR, whereas the latter results in the reassessment of expected cash flows but using the *original* EIR determined at initial recognition.

Ambiguity arises as to which measurement technique should be applied when there are changes in the expected cash flows for instruments that are either partly or wholly variable and the variability in cash flows is driven by an underlying that is deemed to be a closely related embedded

derivative. This is particularly the case for most inflation linked bonds, but is equally applicable for debt instruments where the interest flows are driven from a floating rate, such as LIBOR, but are designed in a way where the guidance in IAS 39.AG33(a) is not breached, say because the interest feature is geared but does not pay more than twice the market rate.

As the two techniques result in very different accounting results it is important that there is clarity about when each method applies. Paragraph 9 in the observer notes for the May 2008 IFRIC meeting (Agenda Paper 6) states that AG7 only applies to floating rate financial instruments where the estimated future cash flows are revised to reflect movements in market rates of interest. In contrast, paragraph 21 of the observer notes states that an entity might determine that an inflation-linked instrument is analogous to a floating rate instrument. However, the tentative agenda decision does not address whether and, if so, in what circumstances, it is appropriate to apply AG7 to inflation linked bonds or other indexed bonds. We are concerned that the absence of guidance will result in diversity in practice and believe the IFRIC should elaborate as to when AG7 applies instead of AG8. If this can be communicated effectively as an agenda decision then IFRIC should proceed on this basis. If it cannot, the IFRIC should consider developing an interpretation on this issue.

(iii) Analogy to IAS 29 Financial Reporting in Hyperinflationary Economies

The observer notes to the May 2008 IFRIC meeting (Agenda Paper 6) made clear that the staff considered that an entity could not analogise to the measurement requirements of IAS 29 if that standard is not being applied. It is our understanding that the IFRIC agreed with the staff. We also concur with this view and suggest that if the IFRIC proceed with an agenda decision that this point is made clear. As currently drafted the tentative agenda decision states that "three possible approaches" were included in the submission (of which one of them was the analogy with IAS 29), yet the tentative agenda decision makes no reference to the IFRIC decision that an analogy to that standard is inappropriate. A statement within the agenda decision confirming that analogy with IAS 29 is not permitted would then remove that question and limit any potential interpretation as an interpretation of IAS 39 only on the application of the EIR.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

cc: Tricia O'Malley, IFRIC Coordinator