30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**15 October 2008, London**
Project:	**IAS 39 *Financial Instruments: Recognition and Measurement***
Subject:	**Application of the Effective Interest Rate Method (Agenda Paper 6)**

PURPOSE OF THIS PAPER

1. In February 2008 the IFRIC received a request for guidance on the application of the effective interest rate method (EIRM) to a financial instrument whose cash flows are linked to changes in an inflation index. The submission asked whether such an instrument is:

    a. a floating rate instrument within the scope of paragraph AG7 of IAS 39 and (if so) how that paragraph should be applied, or

    b. an instrument within the scope of paragraph AG8 of IAS 39.

2. The submission assumed that the inflation mechanism was a closely related embedded derivative (and, thus, was not accounted for separately), and that the instrument was not measured at fair value though profit or loss. Extracts from the original submission are included in Appendix 1.

3. The IFRIC tentatively decided not to add this issue to its agenda at its May 2008 meeting. The IFRIC noted that paragraphs AG6-AG8 of IAS 39 provide

the relevant application guidance and that judgement is required to determine whether an instrument is a floating rate instrument within the scope of paragraph AG7 or an instrument within the scope of paragraph AG8.

4. The IFRIC received two comment letters on its tentative agenda decision, which are included in Appendix 2. Both respondents noted that practice difficulties related to the application of paragraph AG7 are broader than the question raised in the IFRIC submission and that there is diversity in practice.

5. At its July 2008 meeting, the IFRIC confirmed its tentative decision not to add the submission issue to its agenda. The final agenda decision is included in Appendix 3. The IFRIC decided to refer to the Board the broader issue raised by respondents with a recommendation that the Board consider clarifying the existing application guidance (i.e. amending the standard, which is not within the mandate of the IFRIC).

6. This paper asks the Board whether (and if so, what) additional application guidance is needed with regards to:

   a. what is a *floating rate instrument*

   b. how to calculate the effective interest rate (EIR) for floating rate instruments

7. The staff notes there is diversity in practice today on the issues in the preceding paragraph. If the Board decides to do anything, that will result in a change of accounting treatment for some entities.

Requirements of IAS 39

8. Paragraph 9 of IAS 39 defines the effective interest method as “a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.”

9. The EIR is the rate that exactly discounts estimated future cash flows through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the instrument.

10. A shorter period is used in situations in which the variable to which fees, points, transaction costs, and premiums or discounts relate is repriced prior to the expected maturity of the instrument. For example, if a premium on a floating rate instrument reflects changes in market rates since the floating interest rate was reset to market rates, the premium should be amortised to the next reset date. Otherwise, those items are amortised over the expected life of the instrument.

11. Paragraphs AG7 and AG8 provide guidance describing how changes in estimated future cash flows should be included in the EIR calculation.

12. Paragraph AG7 applies to floating rate financial instruments whose estimated future cash flows are revised to reflect movements in market rates of interest. Periodic re-estimations of those cash flows to reflect such movements alter the effective interest rate.

13. Paragraph AG8 applies to changes in estimated future cash flows in financial instruments other than those addressed in paragraph AG7. Periodic re-estimations of cash flows for an instrument in the scope of paragraph AG8 alter the carrying amount of the instrument by discounting the estimated future cash flows at the financial instrument's original EIR. This means that any change in expectations of future cash flows are reflected in the adjusted carrying amount, and that change in the carrying amount is recognized immediately as a gain or loss in profit or loss.

ANALYSIS

What is a 'floating rate instrument'?

14. Many practice difficulties surrounding the application of the EIRM stem from uncertainty about the meaning of the terms *floating rate financial assets* and *floating rate financial liabilities* in paragraph AG7. Although the guidance indicates that estimated future cash flows for those instruments are revised periodically to reflect movements in market rates of interest, it does not elaborate on what is meant by *floating rate*.

15. The staff notes that there are at least three possible ways to address this issue:

a) provide no additional application guidance on the meaning of floating rate instruments (this would be consistent with IFRIC's agenda decision in July)

b) provide application guidance indicating that floating rate instruments are instruments with contractual variable cash flow amounts arising from changes in market variables

c) provide application guidance defining floating rate instruments in some other way.

Each of these alternatives is discussed below.

Alternative 1: Provide no additional guidance

16. As with the IFRIC tentative agenda decision, the Board could decide not to provide additional application guidance on the meaning of floating rate instruments, deferring instead to practitioner judgement.

17. A disadvantage of this alternative is that there would continue to be diversity in practice in the application of the EIRM to instruments with significant expected cash flow variability related to factors other than market interest rates ("non-vanilla instruments").

Alternative 2: Define floating rate instruments as any instrument with contractual variable cash flow amounts arising from changes in market variables

18. The Board could define floating rate instruments by reference to contractual variable cash flow amounts arising from changes in market variables. Examples of market variables for this purpose might include interest rates and inflation rates.

19. However, difficulties may arise in interpreting what is meant by *market variables*. The Board would could attempt to define the term (with all the attendant problems), or simply leave it to the judgement of preparers and auditors.

20. Alternative 2 would result in a broad definition of a *floating rate instrument* and hence a broad application of paragraph AG7. This approach would also result in a change of practice by some entities for some instruments (for example, inflation-linked bonds)

Alternative 3: Define floating rate instruments some other way

21. The Board could define floating rate instruments some other way. For example, floating rate instruments could be restricted to instruments whose interest rates reset to observable market interest rates. This appears consistent with at least some of the language in paragraph AG7 of IAS 39, which refers both to market interest rates and to instruments for which re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset. That is, the carrying amount of a variable rate note purchased at par that has interest payments based on the floating market interest rates will not be significantly affected by re-estimating the future floating interest rates at each reset date.

22. This alternative would result in a more limited application of paragraph AG7 than Alternative 2. Like Alternative 2, this alternative would also change the accounting for some instruments (for example, inflation-linked bonds) by some entities.

Staff recommendation

23. The staff recommends Alternative 2. That is, the staff recommends that the Board define floating rate instruments (for the purposes of applying the EIRM) as any instrument with contractual variable cash flow amounts arising from changes in market variables. However, the staff recommends that the Board not define *market variables* but simply provide some examples.

24. One advantage of Alternative 2 is that it is consistent with much (but not all) of practice. Alternative 2 also remains principle-based, rather than drawing a bright line (as Alternative 3 would). However, the staff questions whether Alternative 2 is consistent with the original intention of the Board.

How to calculate the EIR for floating rate instruments

25. The threshold issue is whether to consider <u>expectations</u> (and changes in expectations) of future cash flows when calculating the EIR for floating rate instruments.

Two approaches to calculating EIR for floating rate instruments

26. For “vanilla” instruments issued or acquired near to or at par, many entities in practice do not project future cash flows but rather simply set the EIR to equal the spot interest rate applicable to the current reporting period (plus or minus the contractual spread on the instrument). In their view, the carrying amount immediately following payment of interest always should be near to or at par. They argue that such an approach is supported by paragraph AG6 that addresses how to account for some types of premiums and discounts on a floating rate instrument, and states:

“*…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.*”

27. An alternative approach is to project estimated cash flows (including current expectations about future interest rates) in calculating the EIR. This would result in the EIR and the spot interest rate for the current period (and hence any cash payments for the current period) being different if the yield curve for the maturity of the instrument is not flat. This would also result in a carrying amount that differs from par immediately following an interest payment/receipt date.

28. The two approaches are illustrated using the following simple example:

On 1 January 20X0, Company ABC issued two-year, variable rate debt with interest payments set at the one-year LIBOR rate. Interest payments are due on 31 December 20X0 and 31 December 20X1. As of 1 January 20X0, the expected one-year LIBOR rates for 20X0 and 20X1 were 5% and 10%, respectively. For purposes of this example, assume that the actual one-year LIBOR rates equalled the above expected rates.

The instrument was issued at par and payment of principal is due in full on 31 December 20X1. Company ABC prepares annual financial statements only.

29. The table below highlights the application of the first approach, as described in paragraph 26 above. Under this approach, the EIR equals the one-year LIBOR rate, resulting in an ending carrying amount of par on 31 December 20X0 (immediately following the interest payment).

Year	Initial Carrying Amount	Interest Expense	Interest Paid	Principal Paid	Ending Carrying Amount
20X0	1,000	50	50	-	1,000
20X1	1,000	100	100	1,000	0

30. The alternative approach whereby entities project estimated cash flows (including current expectations about future interest rates) when calculating the EIR yields different results, as illustrated in the table below. Amounts have been rounded for illustration purposes.

Year	Initial Carrying Amount	Interest Expense	Interest Paid	Principal Paid	Ending Carrying Amount
20X0	1,000	74	50	-	1,024
20X1	1,024	76	100	1,000	0

31. Under the alternative approach, the EIR of 7.41% differs from the one-year LIBOR rate of 5%, resulting in an ending carrying amount that differs from par on 31 December 20X0. Relative to the first approach, the alternative approach tends to "smooth" expense recognition related to changes in the one-year LIBOR rate (i.e., interest expense of 74 and 76 in 20X0 and 20X1, respectively, instead of 50 and 100 for those periods).

32. The staff understands that in practice most entities do not take into account expectations about future interest rates when calculating the EIR for "vanilla" instruments, which is consistent with the first approach above. This reflects the view that re-estimating cash flows to reflect expectations about future interest rates is inconsistent with the guidance in paragraph AG6.

33. There is diversity in practice relative to the application of the EIRM to non-vanilla instruments. Some believe the argument above supports not re-estimating cash flows to reflect expectations about interest rates for non-vanilla instruments.

34. Others disagree and have observed that non-vanilla features (such as a link to inflation) amplify the effects of interest rate movements. They believe that

instruments with those features should be treated differently than vanilla instruments (i.e., entities should be required to re-estimate cash flows for non-vanilla instruments).

Staff recommendation

35. Given the widespread application of the EIRM to floating rate instruments, the staff believes that additional application guidance is needed.

36. The staff recommends that the Board explicitly state that an entity is not required to consider expectations about future interest rates and other market variables when calculating the EIR for floating rate instruments, as defined in this paper.

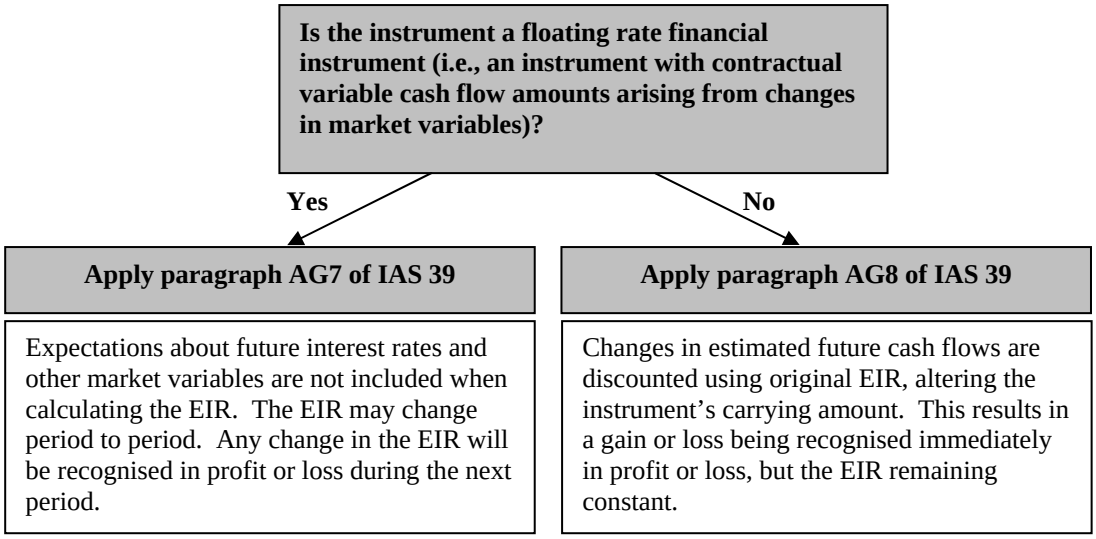
37. The staff believes that this recommendation is consistent with the requirement in paragraph AG6 to amortise fees, points, transaction costs, and other premiums and discounts over the period to which those items relate.

38. Furthermore, the definition of the EIR in paragraph 9 of IAS 39 supports such an approach. The definition allows for the period over which the rate is calculated to be shorter than the expected life of the instrument, when appropriate. That means an instrument may have a number of different EIRs over its life because the instrument may have a number of different periods and an EIR is calculated for each period.

39. The staff also believes that the recommended approach renders an expense recognition pattern that is consistent with the underlying economics of an unhedged floating rate instrument (i.e., the effect on earnings of the cash flow volatility of an instrument that is measured at amortized cost is not "smoothed" by calculating the EIR as if the instrument is some sort of synthetic fixed rate instrument).

SUMMARY OF STAFF RECOMMENDATION

40. The following flowchart summarises the staff's recommendations in the context of paragraphs AG7 and AG8 of IAS 39:



41. If the Board agrees with the above recommendations, the staff recommends that the Board address this issue as part of its Annual Improvements project because the proposed clarifications are not urgent but would require an amendment to IAS 39.

42. The staff notes that the issues raised in this paper do not directly relate to or coincide with those of an active Board project. If the Board were to require fair value measurement for all financial instruments as a result of the discussion paper *Reducing Complexity in Reporting Financial Instruments*, less emphasis would be placed on the EIRM in terms of the measurement of those assets and liabilities. However, for the purpose of income statement presentation (disaggregation), the EIRM may still be required to determine 'interest'.

QUESTIONS FOR THE BOARD

43. The staff recommends that IAS 39 is clarified so only those instruments with contractual variable cash flow amounts arising from changes in market variables are floating rate instruments for the purposes of (a) calculating the EIR, and (b) applying paragraph AG7 and paragraph AG8 of IAS 39. **Does the Board agree with this recommendation? If not, what would the Board like to do, and why?**

44. The staff recommends that IAS 39 is clarified so that expectations about future cash flows are not considered when calculating the EIR for *floating rate*

instruments (as defined). **Does the Board agree with this recommendation? If not, what would the Board like to do, and why?**

45. The staff recommends that the clarifications be included as part of the Annual Improvements project. **Does the Board agree with this recommendation? If not, what would the Board like to do, and why?**

APPENDIX 1

Salient Portions of the February 2008 Submission

The issue: Implementation of the effective interest rate method (EIRM) for indexed linked debt instruments

Question:
How should the effective interest rate method (EIRM) be implemented for a financial debt instrument whose payments (principal and interest) are linked to the changes in inflation index?

Please note that this paper deals only with indexed linked debt instruments which are not carried at fair value through profit or loss, and where the inflation linked mechanism has been found to be closely related embedded derivative and therefore does not need to be recognized and measured separately.

Alternative A - Applying IAS 39.AG8

According to this approach, the EIR of the debt instrument at initial recognition is determined by estimating the future cash flows to be paid on the debt, based on the expected level of the inflation index over the expected term of the debt. The estimated cash flows will be those that, when discounted at the assumed EIR, give rise to an amount equal to the fair value of the debt (usually the issue proceeds).

If in subsequent periods there is a change in the level of the inflation index expectations for the remaining term of the debt instrument, the entity revises its estimates of the future cash flows to be paid on the debt accordingly. It recalculates the carrying amount of the debt instrument by discounting the revised estimated cash flows using the original EIR. The resulting adjustment to the carrying amount of the debt is recognized immediately in the income statement as a gain or loss. The result is that a gain or loss is recognized in the current period for changes in the actual and the expected level of the inflation index.

Alternative B - Applying IAS 39.AG7

Under this approach, the instrument is treated as a floating-rate debt instrument with the inflation link being part of the floating-rate mechanism. The EIR is determined at initial recognition, in the same way as under Alternative A above. However, if in subsequent periods there is a change in inflation expectations, the entity reflects these changes by adjusting both the expected future cash flows on the debt and the EIR.

A question that has arisen here is whether IAS39.AG7 (that deals with floating rate financial instruments) was initially drafted in order to determine the accounting treatment for inflation index linked debt. It is arguable, reading IAS 29.12, that IAS 29 does not prescribe special accounting treatment for monetary items (e.g. debt

financial instruments), and therefore IAS 29.13 should be applied for index linked debt also in non-hyperinflationary economies (see alternative C below).

Alternatively, one can argue that for practical reasons, the implementation of IAS 39.AG7 does not require the estimation of future inflation expectations every balance sheet date. In practice, the EIR on indexed linked debt generally would not need to be adjusted at each repricing date as the effect generally would not be significant. In this case interest expense is recorded in the income statement based on the actual changes in inflation index plus/minus amortization of the discount or premium based on the original EIR. This view is supported by IAS 39.AG7 that states that "…re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability".

Alternative C - Applying the provisions of IAS 29

IAS 29.13 states: " Assets and liabilities linked by agreement to changes in prices, such as index linked bonds and loans, are adjusted in accordance with the agreement in order to ascertain the amount outstanding at the balance sheet date. These items are carried at this adjusted amount in the restated balance sheet".

IAS 29.12 provides that "Monetary items are not restated because they are already expressed in terms of the monetary unit current at the balance sheet date", in the context of this paragraph, it is reasonable to assume that IAS 29.13 refers not only to hyperinflationary economies.

Example from February 2008 Submission

On January 1, 2004, the Company received a loan of CU 100,000, linked to the CPI and bearing CPI-linked interest of 5%. The loan will be repaid in full after five years. The interest on the loan is paid at each year end.

The Company prepares annual financial statements only.

Following are data of actual inflation rates and annual expected inflation rates on various dates:

		Annual expected inflation rates				
	Actual inflation rate	**On 1.1.04**	**On 1.1.05**	**On 1.1.06**	**On 1.1.07**	**On 1.1.08**
2004	1.2%	0.7%	-	-	-	-
2005	2.4%	2.6%	1.4%	-	-	-
2006	0%	2.8%	1.9%	1.7%	-	-
2007	3.4%	2.8%	3.5%	2.1%	1.2%	-
2008	2.5% (assumed)	2.8%	3.5%	2.6%	1.6%	2.5%

Following are the expected cash flows at each date:

1.1.04

Cash flows on	**Amount**	**Calculation**
31.12.04	5,035	=5,000*1.007
31.12.05	5,166	=5,000*1.007*1.026
31.12.06	5,311	=5,000*1.007*1.026*1.028
31.12.07	5,459	=5,000*1.007*1.026*1.028*1.028
31.12.08	117,854	=105,000*1.007*1.026*1.028*1.028*1.028

1.1.05

Cash flows on	Amount	Calculation
31.12.05	5,131	=5,000*1.012*1.014
31.12.06	5,228	=5,000*1.012*1.014*1.019
31.12.07	5,411	=5,000*1.012*1.014*1.019*1.035
31.12.08	117,615	=105,000*1.012*1.014*1.019*1.035*1.035

1.1.06

Cash flows on	Amount	Calculation
31.12.06	5,270	=5,000*1.012*1.024*1.017
31.12.07	5,380	=5,000*1.012*1.024*1.017*1.021
31.12.08	115,921	=105,000*1.012*1.024*1.017*1.021*1.026

1.1.07

Cash flows on	Amount	Calculation
31.12.07	5,244	=5,000*1.012*1.024*1.012
31.12.08	111,878	=105,000*1.012*1.024*1.012*1.016

1.1.08

Cash flows on	Amount	Calculation
31.12.08	115,323	=105,000*1.012*1.024*1.034*1.025

Condensed data and comparison of the various alternatives

	Alternative A (AG8)		Alternative B (AG7)		Alternative C (IAS 29)	
	Financial expenses	**Loan balance**	**Financial expenses**	**Loan balance**	**Financial expenses**	**Loan balance**
31.12.04	7,101	102,041	7,410	102,350	6,260	101,200
31.12.05	6,256	103,116	7,492	104,661	7,610	103,629
31.12.06	3,921	101,856	7,169	106,649	5,181	103,629
31.12.07	10,862	107,367	5,236	106,528	8,881	107,152
31.12.08	7,960	109,835	8,793	109,835	8,168	109,835
Total	**36,100**		**36,100**		**36,100**	

APPENDIX 2

Comments Letters on IFRIC Tentative Agenda Decision

Deloitte Touche Tohmatsu
2 New Street Square
London EC4A 3BZ
United Kingdom

Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198
www.deloitte.com

Direct: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
kwild@deloitte.co.uk

Mr Robert Garnett
Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London
United Kingdom
EC4M 6XH

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

Ernst & Young Global Limited
Becket House
1 Lambeth Palace Road
London SE1 7EU

Tel: +44 (0)20 7980 0000
Fax: +44 (0)20 7980 0275
www.ey.com

International Financial Reporting Interpretations Committee
First Floor
30 Cannon Street
London
EC4M 6XH

17 June 2008

Direct line: 020 7951 3152

Email: leo.van.der.tas@nl.ey.com

Dear IFRIC members

Tentative agenda decision: Application of the effective interest rate method

Ernst & Young is pleased to comment on the above tentative agenda decision.

We do not agree with the tentative agenda decision in respect of the above issue as set out in the May 2008 IFRIC Update.

The question on which the IFRIC was asked for guidance was "How should the effective interest rate method (EIRM) be implemented for a financial debt instrument whose payments (interest and principal) are linked to changes in the inflation index?". The submission included a request for guidance on whether such instruments should be accounted for in accordance with paragraph AG7 or AG8.

The IFRIC issued a rejection notice stating that "judgement is required to determine whether an instrument is a floating rate instrument within the scope of paragraph AG7 or an instrument within the scope of paragraph AG8".

While we agree that judgement is required in making this assessment, there is a wider aspect to the question raised in the submission to which additional guidance is needed in order to make that judgement. That is, how are future inflation expectations to be taken into account when re-estimating cash flows in order to calculate the revised EIR. This is applies to both fixed rate instruments (as raised in the submission) and floating rate instruments where interest is based on LIBOR. There is divergence in views as to whether spot or forward market interest rates should be used to calculate the EIR in accordance with paragraph AG7.

We would ask the IFRIC to reconsider its tentative agenda decision in order to address this question or, failing that, to ask the IASB to provide additional guidance in order to reduce uncertainty and therefore divergence and clarify the Board's original intentions on this matter.

We have also identified divergence in practice when accounting for instruments other than inflation-linked bonds and have experienced a number of other practical difficulties when interpreting the wording of paragraphs AG7 and AG8. In our view these difficulties stem largely from a lack of definition or clarity as to the meaning of certain key terms used in the

paragraphs, such as "market rate of interest", and "floating rate financial asset or liability". As a result, it is often difficult to determine which of the two paragraphs should be applied to a specific instrument.

Other practical difficulties arise from a lack of clarity as to the interaction of these paragraphs with the requirements relating to embedded derivatives, particularly in paragraph AG 33, or how the requirements in paragraphs AG7 and AG8 apply to pre-payment and similar options.

As a result of the complexity of the products involved and differing views on interpretation, preparers of the accounts face significant uncertainties and difficulties when applying paragraphs AG7, AG8 or AG33.

It may be more appropriate for the Board rather than the IFRIC to address these issues. We are happy to share and discuss with IFRIC and IASB staff the issues we have come across in more detail, and would welcome more guidance on the principles behind paragraphs AG7 and AG8.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas on 020 7951 3152 or at the above address.

Yours faithfully

Ernst & Young

APPENDIX 3

Final IFRIC Agenda Decision

Application of the effective interest rate method

The IFRIC was asked for guidance on the application of the effective interest rate method to a financial instrument whose cash flows are linked to changes in an inflation index. The submission suggested three possible approaches.

The IFRIC noted that paragraphs AG6–AG8 of IAS 39 *Financial Instruments: Recognition and Measurement* provide the relevant application guidance. Judgement is required to determine whether an instrument is a floating rate instrument within the scope of paragraph AG7 or an instrument within the scope of paragraph AG8.

In view of the existing application guidance in IAS 39, the IFRIC decided not to add this issue to its agenda. However, the IFRIC referred the issue to the Board with a recommendation that the Board should consider clarifying or expanding that application guidance.