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International Financial Reporting Interpretations
Committee
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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