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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2008, London**

Project: **Applying the Effective Interest Rate Method (Agenda Paper 5**

Tentative Agenda Decision Published in the May 2008 IFRIC Update

1. In May 2008, the IFRIC made the following tentative agenda decision:

> 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 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.

Comment Letters Received on the Tentative Agenda Decision

2. The IFRIC received two comment letters on the tentative agenda decision (see Agenda Paper 5 Attachments 1-2). Both respondents requested further consideration of this issue by either the IFRIC or the IASB.

3. Both comment letters noted that practice problems related to the effective interest rate method (EIRM) are broader than accounting for inflation-linked instruments, which was the issue raised in the IFRIC submission. The respondents stated that the guidance in IAS 39 related to the EIRM is unclear resulting in considerable uncertainty and diversity in practice and that additional guidance is needed.

4. The respondents noted that the EIRM has widespread application for both simple and complex financial instruments yet sometimes it is unclear how the EIRM should be applied to instruments with variable cash flows. Specifically, the respondents noted that the following issues need to be addressed:

   a. **How is the EIRM applied to instruments whose interest rates are reset to market rates?**

      The respondents noted that it is unclear whether future expectations about interest rates should be taken into account when estimating future cash flows in order to calculate the effective interest rate.

   b. **When should an entity apply paragraph AG7 rather than paragraph AG8?**

      The respondents noted that the two measurement techniques have very different accounting results but sometimes ambiguity arises as to which technique should be applied to a specific instrument (for example, an inflation-linked instrument).

5. Both respondents asked the IFRIC either to interpret the existing guidance in IAS 39 or to recommend that the IASB provide additional guidance.

Staff recommendation

6. Consistent with the staff's recommendation in May, the staff recommends that the IFRIC not add the issue to its agenda.

7. Based on the comments received, it is clear that the practice problems related to the EIRM are more wide-ranging than the issue raised in the submission on inflation-linked instruments. Furthermore, the staff thinks that it may be impossible for IFRIC to interpret the application guidance in IAS 39 because that guidance is unclear.

8. Consequently, the staff recommends that the IFRIC should refer the issue to the Board with a recommendation that the IASB consider issues related to the EIRM in its Annual Improvements project.

Proposed <u>Revised</u> Agenda Decision

9. [Paragraph omitted from observer note].

Question for the IFRIC

10. Does the IFRIC agree with the staff recommendation? If not, how does the IFRIC wish to proceed with the issue?