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**Deloitte
Touche
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2 July 2004

Mr Stig Enevoldsen
European Financial Reporting Advisory Group
Avenues des Arts 41
1040 Brussels
Belgium

Dear Sir

Re: EFRAG's Draft letter of endorsement of 'IAS 39 Financial Instruments: Recognition and Measurement'

Deloitte Touche Tohmatsu has considered your draft letter dated 4 June, addressed to Dr Schaub and concerning the EU adoption of the amended 'IAS 39 Financial Instruments: Recognition and Measurement.' We believe the draft achieves a balance in reflecting the arguments that have been put forward both in favour and in opposition to the endorsement of IAS 39 in Europe

Deloitte very strongly supports both the development of IFRS as a set of global standards, and the process initiated by the European Union to use such standards as the basis for a set of common requirements to be used by all listed companies in Europe. In our view it is vital for EFRAG ultimately to conclude that it is in the interest of investors in the international capital markets and in the European public good to adopt IAS 39 Financial Instruments: Recognition and Measurement as a means of facilitating this process in time for the 2005 implementation date.

Whilst IAS 39 is not perfect, there is much to be warmly welcomed. We believe the principles for hedge accounting established by IAS 39 are sound and will, if adopted, provide a model for recognition and measurement that, notwithstanding the shortcomings, will enhance the transparency and consistency of corporate reporting, including reporting by financial institutions, across the EU.

We acknowledge there is an urgent need, within the principles of hedge accounting, to find solutions that allow risk management practices that are tried and tested in the financial services industry to be appropriately accommodated in the detailed rules for hedge accounting. The principal identified area of concern is the lack of accommodation within IAS 39 for taking into account the behavioural aspects of a demand deposit portfolio. Like EFRAG, Deloitte accepts that liabilities with a demand feature, that in practice remain outstanding over a long period of time, have an economic value that is not currently reflected in the financial statements. We agree with the unanimous view of EFRAG members that it is important to find an acceptable method under the Framework to capture the effects of hedging strategies that rely on that value.

No set of globally acceptable accounting standards can be complete without a standard on the recognition and measurement of financial instruments. Whilst we regret that it has so far proved impossible to resolve some of the issues which have been raised in Europe, in particular by the financial services industry, and which are reflected in the EFRAG letter to the European Commission, we note that IAS 39 is not untried and untested for those entities around the world already reporting under IFRS. It is already a globally recognised and applied standard in some jurisdictions outside Europe. We do not see any advantage to an EU listed group that does not adopt IAS 32 and IAS 39 as it will fail to benefit from increased comparability with current IAS reporters and US reporters that adopt similar rules in this area. Also, long term and long sought after benefits will be forsaken, such as the increased confidence of the EU in global capital markets, international harmonisation and uniform corporate responsibility in the provision of complete and transparent information to shareholders.

The consequences for the transition to IFRS in accordance with Regulation (EC) No 1606/2002 without a fully endorsed and wholly supported standard on the recognition and measurement of financial instruments, are far-reaching and damaging, in terms of continued and increased acceptance of international accounting standards around the world and the credibility of the EU and its capital markets, and in practical and financial terms:

- From a practical perspective we do not know how preparers could conceivably deal with the uncertainty and complexities regarding the cross-references to IAS 39 in the other IASs and IFRSs which would arise if IAS 39 is not endorsed. IAS 1 (Revised), IAS 8 (Revised), IAS 12, IAS 17, IAS 18, IAS 21, IAS 27 (Revised), IAS 28 (Revised), IAS 30, IAS 31 (Revised), IAS 32 (Revised), IAS 33 (Revised), IAS 36 (Revised), IFRS 1, IFRS 2, IFRS 3, IFRS 4 and IFRS 5 all refer the preparer to IAS 39. In short, wherever fair value measurement is required by a standard, it often refers the user to the fair value hierarchy in IAS 39.
- Non-endorsement of IAS 39 would potentially disqualify European companies from using IFRS 1. This would create immense and potentially insurmountable problems for companies intending to use IFRS 1's permitted elective exemptions from retrospective application, and could lead to calls for a re-write of that standard and re-endorsement as appropriate.
- The hierarchy in IAS 8.10 requires management to consider the pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, in the absence of a Standard or Interpretation that specifically applies to a transaction in developing its accounting policy for that transaction. In the absence of an endorsed IAS 39, it is difficult to see how any globally acceptable accounting standard other than 'FAS 133 Accounting for Derivatives and Hedging Activities' in the US could meet this requirement of IAS 8.
- European entities required to apply IFRS from 2005 have spent considerable resources for the purposes of implementation of IAS 39 alone.

In conclusion, without a standard on the recognition and measurement of financial instruments the high quality of financial reporting on which so many parties depend will be severely undermined. We acknowledge the concerns about the standard and share many of them. The

same can be said of IAS 32. If the shortcomings in either of these standards were such as to make them unworkable, then it would clearly be wrong to recommend adoption.

In our letter of 21 November 2003 addressed to Sir David Tweedie, commenting on proposed amendments to IAS 39, we acknowledged the concerns of some European banks, and urged the Board to give serious consideration to any evidence based research they might produce to demonstrate that:

- Their business model varies so substantially from those of banks elsewhere in the world that already apply IAS 39 (or FAS 133), and
- The harmful impacts of IAS 39, as seen by them, would be so severe as to make IAS 39 unworkable (i.e., not possible to show a true and fair view).

In the absence of such evidence it cannot, in our view, be easily concluded that the shortcomings cause the Standard to be unworkable. Indeed, recent analyst research* on the impact of IAS on European banks argues that the accounting changes should have no meaningful impact on investors' views. Consequently, we believe the benefits that would result from adoption of IAS 39 in time for application from 1 January 2005 outweigh the shortcomings, and we agree with the overall conclusion in favour of endorsement as currently set out in the draft EFRAG letter. We do not support the concept of a temporary exemption such as that suggested by the dissenting EFRAG members.

However, it is important to note that the analyst research expects the investor market (and the regulators) simply to 'look through the accounting mumbo jumbo' where they believe the accounting shows a misleading picture of the economic underlying reality. Standard setters and regulators must be concerned by this rather damning comment on the usefulness of IAS accounts as a basis for investor communication and understanding. It is critical therefore that the IASB does not regard endorsement as the end of the debate. We encourage EFRAG to continue to work with the IASB to assist the Board in developing a satisfactory process to dialogue effectively, within a pre-agreed timeframe, with the European preparers, and thereby to take better account of the diversity of geographies and industries.

The above points would apply equally to IAS 32, which we would also wish to see endorsed as soon as possible.

Yours faithfully

Deloitte Touche Tohmatsu

* Merrill Lynch: IAS – Measuring the Impact on European Banks. 22 June 2004.

cc Mr Frits Bolkestein