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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Dear Sir David,

What Performance Reporting Should Be:
Comments on the IASB Staff Proposal

We, the members of the Performance Reporting Project Team of the Accounting Standards Board of Japan (ASBJ), respect IASB's efforts to converge performance reporting. However, we have some doubts about the IASB Staff Proposal, which aims to restructure the format of performance reporting from a zero-based review. We believe that the existing US standard on performance reporting is already globally accepted and also is more reasonable than the Staff Proposal arising from the joint work done by IASB and UK ASB. Therefore, <u>we support convergence of performance reporting based on the existing US standard, with appropriate improvements.</u>

If the proposal being discussed by IASB is adopted, "net income" disclosed under the existing standards of Japan and the US would no longer be disclosed in performance reporting. The Japanese business community has critical feelings towards such a proposal. "Net income" is considered to be one of the most useful accounting measures, and its usefulness is supported by many empirical studies. In addition, in light of the fact that the majority of US enterprises continue to report "other comprehensive income" in statements of shareholders' equity even after the introduction of FAS 130, it would be a reasonable conjecture that many executives and analysts do not regard "other comprehensive income" as a measure of performance. <u>A questionnaire survey recently carried out in Japan shows that, here also, a large majority of executives and</u>

analysts do not regard "other comprehensive income" as an indicator of "performance". Moreover, it should be noted that net income rather than comprehensive income is continuously used as a numerator for EPS, which analysts think much of. This indicates that net income is at least one of the most important measures, if not the most important. If convergence of performance reporting is achieved in line with the IASB Staff Proposal and net income is no longer disclosed, the calculation of EPS under the existing method would become difficult.

The IASB Staff Proposal, in summary, regards comprehensive income (the total amount of valuation differences, recognized during a period, for assets and liabilities) as a measure of performance and, by disclosing its components, intends to be helpful to investors making investment decisions. We understand this is based on the view that the various components of income have more information value than one single performance measure has. However, it should be noted that "fair value" itself (stock information) and "changes in fair value during the period" (flow information) do not have the same information value. The fact that the fair value of assets and liabilities has information value does not necessarily mean that changes in fair value during a period also have information value. In cases where the value of assets and liabilities is determined independently of the concept of "performance", it is not appropriate to automatically consider the valuation differences of assets and liabilities (comprehensive income) as information representing "performance" (results of investment). Although we do not strongly oppose calculating comprehensive income based on the valuation differences of stock, this need not, and should not, preclude the disclosure of net income as information about the results of investment.

The primary purpose of accounting information is considered to be to inform decision making for investment. Accounting information is not only used to form ex-ante expectations about future income / cash flow, which is necessary to estimate the present value of capital for shareholders, but also used as feedback information for ex-post revision of the ex-ante expectations and for the formation of new expectations. For this reason, it is said that accounting information has feedback value as well as prediction value.

First and foremost, "performance reporting" must be useful in predicting future. Only sustainable factors are useful in the prediction of future income / cash flow. Generally, the components of "other comprehensive income" that are valuation differences are only temporary factors. However, there may be cases where they must be recognized as sustainable factors, through subsequent recycling. Typical examples of this are the reclassification required when applying hedge accounting for cash flow hedges and the reclassification required when recognizing appraisal gains on tangible fixed assets (→ depreciation based on the historical cost).

We consider that the "performance" to be included in "performance reporting" should be ex-post information about the results of investment. It should be information about how much surplus was earned from the invested capital after its release from business risks. It should enable investors to revise ex-ante expectations about the investment and thereby form updated expectations for the future. In this context, "release from business risks" means, in the case of real business investments, that cash, in the broad meaning (including trade receivables), flows into the enterprise. In the case of financial investments, the changes in fair value can be considered as the results of investment, because those investments are free from business risks from the very beginning. This is why valuation differences in trading securities are included in net profit or loss for the period. Therefore, if any components of other comprehensive income, which had not been released from business risks when recognized as valuation differences, are subsequently released from business risks, they must be recycled (reclassified) to performance. Only through this process, can the long-term continuity of time series of performance and income as results of investments be maintained and the long-term total of stream of net income achieve concordance with that of comprehensive income.

It is sometimes argued that information as to release from business risks can be obtained from cash flow statements. However, the information obtainable from cash flow statements is information about funds that have been released from not only business risks but also credit risks. An enterprise is released from business risks by obtaining of trade receivables. This is not displayed in cash flow statements. Results of empirical studies show that information about accruals, which represent the result of investment, has more value than general, or undifferentiated, cash flow information. Cash flow information cannot perfectly substitute for information about the results of investments.

Finally, we would like to note that the existing IAS 16 permits a choice between the historical cost model and the current value model for tangible fixed assets. Given the existence of such a choice, what meaning does it have to designate as "performance" changes in the net assets of different enterprises, which can freely choose between the two models? And how can comparability be ensured? We would call on IASB to give sufficient explanations regarding these questions.

Here is a summary of our opinions:

1. Convergence of performance reporting should be based on the existing US standard, which is widely accepted in practice and also, we believe, theoretically superior. We do not consider it necessary to establish an entirely new format for performance reporting, or to converge thereon.

2. We do not object to reporting other comprehensive income but we believe that net income (equivalent to that reported under existing US GAAP) should continue to be disclosed, at least as a subtotal item. And recycling from "other comprehensive income" to "net income" should be permitted, so that the reporting of net income continues to have high information value.

Yours sincerely,

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