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International Accounting Standards Board
30 Cannon Street
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Comments on the Discussion Paper
"Reducing Complexity in Reporting Financial Instruments"

Dear Sirs/Madams,

We appreciate the IASB's efforts on the Financial Instruments project for many years and welcome the opportunity to provide comments on the Discussion Paper (the DP), *Reducing Complexity in Reporting Financial Instruments*. The comments are those of the Financial Instruments Technical Committee of the Accounting Standards Board of Japan.

We are aware of the complexity in reporting financial instruments. Such complexity may result from unavoidable complexity of transactions concerning financial instruments. However, unnecessary complexity can also arise and it may impose unnecessary cost on all participants in the financial reporting process. Therefore, reducing unnecessary complexity by simplifying requirements in light of its objective is desirable, and in that sense we support that the IASB will consider intermediate approach mainly focusing on simplification of hedge accounting.

We do not necessarily agree with the argument for the suggested long-term solution. Even if fair value may be the appropriate measurement attribute for financial instruments in many cases, critical problems pertinent to the suggested solution remain unsolved. Moreover, we are concerned that in this solution the change in the fair value for all types of financial instruments is included in earnings which represents a total performance indicator.

The attachment of this letter sets out our responses to individual questions placed at the end of each section in the DP.

We hope that our comments will contribute to the IASB's future deliberation in this project.

Sincerely yours,

Ikuo Nishikawa
Chairman, Financial Instruments Technical Committee
Chairman, Accounting Standards Board of Japan

Attachment　Responses to individual questions

Section 1　Problems related to measurement

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

1. We share the concern that the current financial reporting of financial instruments is complicated. If unnecessary complexity arises due to excessively rigid treatments such as in hedge accounting, we agree with IASB's exploring how to reduce such complexity in those treatments and improve them. However, complexity may result from unavoidable complexity of transactions related to financial instruments. Too much simplification may cause the loss of information to users of financial reporting and this matter should be well taken into account.
2. As the DP explains, one of the causes of complexity is the many ways of measuring financial instruments. Also, other causes such as the complexity of financial instruments themselves and the complexity of treatment in the area other than measurement-related one (e.g., derecognition) are presented in paragraphs BD 14 and BD 16. The many ways of measuring financial instruments is not the only important cause of complexity. It is not appropriate to place less emphasis on other causes.
3. Paragraph 1.6 lists problems for constituents created by many ways of measuring financial instruments. These problems serve as a starting point to seek possible solutions which will be discussed in the following sections. We are of the view that the IASB should analyze whether these problems are pertinent to the need for significant change and share its results among constituents. We share the concern in the item (f) of paragraph 1.6 that the maintenance and interpretation of those numerous and complex requirements are difficult and time-consuming. On the other hand, it seems to us that the concern in the item (d), that "different gains or losses result from different measurement methods", does not imply deficiency in the current standards. The current accounting standards as a whole adopt the mixed measurement attributes for non-financial items, too. In the mixed measurement attribute system, a measurement method among them is selected in relation to entity's business activity, which is not a problem in itself but is rather essential to make financial reporting useful. Furthermore, the item (c) states that inappropriate choice or improper documentation may require management to restate prior period financial statements. Regarding this problem, the management of a reporting entity may be responsible or some improvement to the current standards may be enough. Therefore, it is not appropriate to ascribe such a problem only to the mixed measurement attributes for financial instruments.

4. We are of the view that individually addressing specific problems suggested by constituents is also an important step to remove constituents concerns even if these efforts do not lead to significant change. So far, the IASB have dealt with those problems related to accounting for financial instruments and we appreciate those efforts.

Section 2 Intermediate approaches to measurement and related problems

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

5. With regard to Question 2(a), we do not support measuring all types of financial instruments in the same way and we are of the view that it is useful if the IASB considers the possible intermediate approaches mainly on simplification of hedge accounting for the purpose of reducing unnecessary complexity. This is because (a) we think that the proposed long-term goal is not appropriate as in the response to Questions 8 and 9 (in paragraphs 16 and 17 of this letter), and (b) improving the current requirements without overall change is a more cost effective way to address the complexity, and the resulting change is easier for constituents to apply.
6. With regard to Question 2(b), we agree with the criterion (a) in paragraph 2.2 which states that a change should provide more relevant information. For that purpose, however, decision making model of users should be shared, otherwise it would be difficult to determine whether certain approach provides more relevant information. We do not agree with the criterion (b) in paragraph 2.2 because we do not see, at present, that measuring all types of financial instruments at fair value is a long-term goal.

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

7. We do not agree to eliminate the available-for-sale category (See paragraph 2.11). However, this category includes various kinds of financial instruments, so we do not object to possible reconsideration of what should be included in this category which may result in narrowing the scope of the category if necessary so long as the resulting change does not increase complexity.

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(b) How should instruments that are not measured at fair value be measured?

(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?

(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?

8. Approach 2 establishes a fair value measurement principle, though it entails some optional exceptions. We do not agree with this approach because this is a step toward general fair value measurement principle as stated in paragraph 2.21(a). In addition, we are of the view that the proposed approach does not necessarily simplify accounting requirements. This is because the approach continues to need requirements for impairment (See paragraph 3.27 with respect to the issues of impairment the DP recognizes), as well as, requirements to limit transfer between the principle (fair value measurement) and exceptions (cost-based measurement) which might be as rigid as those imposed on the current held-to-maturity category, for anti-abuse purposes.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

(i) Which method(s) should the IASB consider, and why?

(ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2?

If you suggest changing measurement requirements under approach 1 or approach 2, please ensure that your comments are consistent with your suggested approach to changing measurement requirements.

9. With respect to Question 5(a), we are not of the view that hedge accounting should be eliminated entirely. The followings are our reasons:

- As stated in paragraph 2.33, resulting volatility in earnings after eliminating hedge accounting does not reflect the economic consequences of hedging activities.
- As stated in paragraphs 2.29 and 2.34, necessity of cash flow hedge accounting is not affected by changing the general measurement requirement for financial instruments.

- Even if all types of financial instruments were measured at fair value, hedge accounting would still be necessary to reflect the hedging relationship between financial items and non-financial items.

10. With respect to Question 5(b), among three possibilities listed in paragraph 2.35, adding flexibility as in paragraph 2.40 to fair value option to replace fair value hedge accounting (paragraph 2.35(a)) seems worth exploring. In addition, permitting recognition of gains or losses on hedging instruments outside earnings (paragraph 2.35(b)) seems worth exploring. This approach has advantages described in paragraph 2.46 and would unify accounting treatments in the fair value hedge and cash flow hedge.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?

(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?

(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.

(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

11. The approach allowing an entity to set initially a general policy for effectiveness testing that would include fallback position as in paragraph 2.61 seems to be one of the reasonable possibilities if the restatement of prior year financial statements in paragraph 1.6(c) indicates serious flaws of accounting standards.

12. If, as an alternative, effectiveness requirement in hedge relationship is relaxed only to some extent, hedging effect would still be appropriately reflected in financial statements and it would be unlikely to mislead users provided that ineffectiveness is continuously recognized in earnings. The exposure draft from the FASB "Accounting for Hedging Activities – an amendment of FASB Statement No.133" (hereafter "the amendment of FAS 133 ED") would be an informative proposal.

    (1) It requires hedging relationship to be reasonably effective, not highly effective.

    (2) It requires qualitative reassessment of effectiveness and requires quantitative reassessment

only when it is necessary.

(3) Currently FAS 133 requires ongoing effectiveness test, but the amendment of FAS 133 ED eliminates it.

13. The possible approach to reduce the frequency of dedesignation and redesignation of the hedge relationship in paragraph 2.64 is worth exploring. This is because the economics of the relationship between the hedging instrument and hedged item substantially remains if the same position continues after dedesignation. The amendment of FAS 133 ED also proposes to eliminate a situation of the dedesignation of the hedge relationship regarding when an entity discontinues hedge accounting.

14. With respect to Question 6(c), we are of the view that partial hedges should be permitted. A partial hedge in the cases of (b) and (c) in paragraph 2.66 can be considered substantially equivalent to the case where an entity transacts in a smaller amount and applies a normal hedge accounting to such a transaction. Complexity arising from a partial hedge in this case already exists in a normal hedge and no new complexity is brought about by a partial hedge. On the other hand, as in the case of (a) in paragraph 2.66, there are many practical instances that an entity hedges not all the risk of an item but only an individual risk using a corresponding hedging instrument (e.g. an interest rate swap for interest risk). If this case is not treated as a partial hedge, the economics of the hedging relationship would not be reflected in the financial statements.

Question 7 Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

15. There are some cases that current accounting standards for financial instruments provide requirements of detailed and punitive nature for anti-abuse purposes. One such example may be a tainting rule for held-to-maturity investments. It is worth considering the possibility of simplification of the current standard by eliminating requirements of this nature.

Section 3 A long-term solution—a single measurement method for all types of financial instruments

Question 8 To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments. Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is

there another approach to address measurement-related problems in the long term? If so, what is it?

16. We do not necessarily agree with the view that the long-term solution would be to measure all types of financial instruments using a single method with all changes included in earnings. Instead, we are of the view that improvement based on the current mixed measurement attribute would be more reasonable. Reasons are as follows:
    (1) As is clear from entity valuation models, earnings, which represent current performance, play an important role in users' decision making. Consequently, even when financial instruments are required to be measured using such a single method, earnings information must be made useful in order to achieve the objective of financial reporting. As is often stated in the DP, users of financial statements are still interested in breakdowns of total change in fair value, such as changes due to interest accrual (paragraphs 3.29, 3.42, 3.49, 3.50, and 3.82), which alternatively indicates their needs for useful earnings information based on mixed measurement attribute model.
    (2) If an entity calculates balance sheet information using a single measurement method and also has to disaggregate the changes, additional calculation is needed for disaggregation. It would result in using more than one measurement method after all and would not lead to reducing complexity for preparers and auditors.
    (3) We are of the view that it is reasonable to use a single measurement method for items not based on their form (e.g. financial instruments) but based on their substance. For example, the IFRSs apply different measurement attributes to non-financial items as well as financial items based on the substance of the investment, like for sale or for trading (IAS 2 "Inventories"), or for internal use (IAS 16 "Property, Plant and Equipment"). In addition, the DP excludes in paragraph A23 equity instruments that convey control of an entity or significant influence over an entity from the scope of the accounting standards for financial instruments, which seems to indicate that the substance of investment is already taken into account. It seems to us that an effective approach to measurement-related issues of accounting standards as a whole would be that an entity applies the same measurement method to items not in the same form but in the same substance.

Question 9

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

17. As in the response to Q8, we do not necessarily agree with the view that applying the single measurement attribute to all types of financial instruments is a desirable long-term solution. In many cases reliable fair value is considered to be appropriate measurements for financial instruments. However, we have following concerns if all types of financial instruments are measured at fair value with its change included in earnings which represents a total performance indicator.
    (1) Even in the case that the single measurement attribute at fair value is established, as in the response to Q5, there are still needs for cash flow hedge accounting, i.e., there should be a treatment for a change in fair value to be deferred temporarily outside earnings.
    (2) Such measurement attributes other than fair value as the accretion or amortization of cost or the equity method under the existing mixed measurement attribute provides users with necessary information to assess future cash flow prospects through earnings information. Balance sheet information as fair value alone may be useful for assessing cash flow prospects for some financial instruments, but it would be limited to the case where their value does not depend on management effort, their active markets are in place, and you can sell them without any business constraints (e.g., financial instruments held for trading).
    (3) Changes in fair value that would not be considered as a performance would be included in earnings. We are of the view that such kind of changes should be separated from earnings. Even supporters of fair value acknowledge that a separation of unrealized gains and losses attributable to changes in market factors is important (paragraph 3.42).
18. As in paragraph 3.78, there still remain concerns of the reliability of fair value, especially as to financial instruments whose market-based information is not readily available. Paragraph 3.80 states that the same difficulty and uncertainty as in estimating fair values exist today in estimating impairment losses of an impaired financial asset. However, if financial instruments are measured at fair value each reporting period, their measurement would likely be more exposed to management's discretion. The same paragraph also notes that fair values of most financial instruments are required to be disclosed by today's financial reporting standards. But this requirement alone has not completely removed the difficulty and uncertainty in estimating fair values and the issue of reliability potentially continues to remain. The recent credit crisis has triggered awareness of the issue on fair value measurement of financial instruments whose markets are no longer active, which shows that the measurement problem is not necessarily resolved. If the measurement is imprecise but not to a large extent, then the imprecise estimate with relevance may be more useful than the precise value with little relevance. In this case, fair

value may be more useful than cost (paragraph 3.63). However, if, at least, the measured value is largely imprecise, decision usefulness would be impaired, even though the relevance does not relate to reliability.

19. In this regard, however, there may be room for reconsideration as to what should be included in each category even if the mixed measurement attributes continues (see paragraph 7 in the response to Q3 of this letter).

Question 10 Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

20. No significant concern is left other than listed in part B of the section 3. We have very serious concern with the treatment that gains are included in earnings as credit risk of the entity increases, as in paragraph 3.75.
21. Fair value measurement of a financial liability includes a fundamental problem regarding the objective of financial reporting. Enterprise value is the sum of value of business or operating investments and the fair value of net financial investments. This enterprise value is allocated to each claim (debt and equity instruments). Under the financial reporting system, earnings and other information are disclosed so that such information is helpful for enhancing investors' capacity to predict the enterprise value including goodwill at their own responsibility. Regarding a financial liability which funds an investment not readily convertible to cash, if management reports the fair value of the financial liability with its change recognized in earnings, that would lead management to present its view about the enterprise value for investors and be inconsistent with the assumption of the financial reporting system that the investors themselves estimate the enterprise value including internally generated goodwill based on information of financial reporting.
22. We understand that the IASB is now addressing the problem regarding the valuation of financial instruments whose market is no longer active. We appreciate the IASB's effort in this area and expect the outcome.

Question 11 Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments. (a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

23. The scope of fair value measurement with its changes included in earnings should be determined not based on the form of the investment but on the substance of the investment. (See the paragraph 16(3) of this letter)

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

24. The DP does not set out preliminary views of the IASB, so the IASB should issue another discussion paper with preliminary views about intermediate approach before moving on to the process of an exposure draft.