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September 1, 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir or Madame,

Comments on the Discussion Paper
"Credit Risk in Liability Measurement"

We appreciate the IASB's efforts in preparing the Discussion Paper on the treatment of credit risk in measurement of liabilities, which is a cross cutting issue across several projects, and welcome the opportunity to comment on that subject. The views in the following paragraphs are those of the Technical Committee for Financial Instruments within the Accounting Standards Board of Japan.

General Comments

1. We need distinguish between (a) the issue of whether credit risk should be included in fair value measurement of liabilities and (b) the issue of to what extent measures including credit risk should be used for liabilities. We do not believe that it would be appropriate to incorporate the price of credit risk in measurement of all liabilities at initial recognition, although we acknowledge that credit risk would be included in fair value measurement if a liability should be measured at fair value. Furthermore, after initial recognition, liabilities with fixed contractual cash flows generally do not need remeasurement and, even for liabilities which need remeasurement, measurement excluding the effect of credit risk would be more useful in many cases. Accordingly, in our view, it is in very limited situations such as measurement of derivatives that use of fair value for remeasurement of liabilities would be appropriate (see paragraph 6 of this comment letter as a response to Question 2).

2. The Staff Paper accompanying the DP outlines the three most often-cited arguments in favour of including credit risk and the three most

often-cited arguments against. In our view, arguments against including credit risk are more persuasive and encompass important points from the perspective of decision usefulness of financial reporting.

3. Arguments in favour of including credit risk, outlined in the Staff Paper, are merely justification for incorporating credit risk in measurement of liabilities in limited situations, in our view. We would like to specifically point out the following:

a) Consistency at initial recognition

For liabilities of which contractual cash flows include interest charged on the principal, we admit that including credit risk in measurement at initial recognition is appropriate. However, for other liabilities, we do not believe that including credit risk in measurement at initial recognition would be appropriate. We do not consider it to be inconsistency, because this discrimination is based on the difference of those liabilities from borrowings in the basic characteristics and it directly affects the amount of income and expenses resulting from recognition of those liabilities (see paragraph 5 of this comment letter as a response to Question 1).

b) Wealth transfer

The Staff Paper outlines an argument that a change in the credit risk of the entity's liabilities represents a transfer of wealth between the two classes of claims against the entity and recognition of a gain to the borrower can be justified. However, this merely states that recognition of a decrease in fair value of a liability would result in recognition of a gain as an increase of the value of the entity's equity, assuming the value of the entity as a whole is unchanged. It is not a rationale for recognising a decrease in fair value of a liability. There are many cases where a change in the value of an entity's equity is not recognised as income or expense. Furthermore, considering that an increase in the credit risk of the entity's liabilities is often accompanied with a decline in the value of unrecognised intangible assets, the value of the entity as a whole might have decreased. The fact that an increase in the credit risk of the entity's liabilities represents a transfer of wealth from lenders to owners only means that recognition of a gain would not be necessarily denied conceptually. It cannot be a rationale that measuring a liability

at fair value and recognising a resultant gain would improve decision usefulness of financial statements.

c) Accounting mismatch

The example shown in paragraph 43 of the Staff Paper is a very artificial situation that all of the assets are debt instruments. However, in reality, accounting mismatch cited in an argument against incorporating credit risk (paragraph 53-57 of the Staff Paper) is more common. That is, for many of entities in the real world, a considerable portion of the decrease in the value of the entity as a whole corresponding to the deterioration of creditworthiness of the entity are attributable to an decline in the value of the assets including unrecognised intangible assets, for which losses are not recognised in financial statements. Therefore, in many cases, recognition of a gain on a decrease in fair value of liabilities would generate accounting mismatch.

<u>Responses to specific questions</u>

(Question 1)

4. We support the alternative (b), that is, measurement of liabilities at initial recognition should sometimes incorporate the price of credit risk inherent to the liabilities. For liabilities such as borrowings that involve exchanges with cash or liabilities whose contractual cash flows include interests on the principal, the price of credit risk should be incorporated in the measurement at initial recognition. From the perspective of economical reasonableness, a liability at initial recognition should be regarded as having an equal value to the cash received or the contractual cash flows and therefore not incorporating the credit risk in initial measurement would lead to unreasonable consequence.

5. However, for other liabilities, there is no necessity that fair value should be used at initial measurement. Rather, we believe that incorporating credit risk in measurement of those liabilities would be inappropriate. We believe that this discrimination is not inconsistency because it is based on difference in the basic characteristics of the respective liabilities and .it directly affects the amount of gains or losses recognized as a result of recognition of those liabilities. If discounts by credit risk and their

changes are difficult to realise, not incorporating credit risk in measurement of liabilities would be useful in predicting future cash flows so as not to reflect those amounts in profit or loss. Furthermore, it would impair decision usefulness that an entity with higher credit risk recognises a less amount of liability for an obligation with the identical amounts and timing of future payments, because such consequence cannot be considered as fairly stating the financial position.

(Question 2)

6. We support the alternative (b), that is, current measurement of liabilities after initial recognition should sometimes incorporate the price of credit risk inherent to the liabilities. However, for subsequent measurement, we believe that the situation where it is appropriate to include credit risk would be more limited than for initial measurement. Even for liabilities such as loans for which inclusion of credit risk is appropriate at initial measurement, inclusion of credit risk at subsequent measurement would be generally inappropriate, except for derivatives. It is because all of the problems that the Staff Paper cites as arguments against inclusion of credit risk, that is, counter-intuitive results, accounting mismatch and recognition of a gain unrealisable in most situations, would arise. Compared with the significance of these problems, the arguments in favour of inclusion of credit risk cited in the Staff Paper cannot be sufficient justification for incorporating credit risk in measurement of liabilities, as mentioned in the General Comments (see paragraph 3 of this comment letter).

(Question 3)

7. We suggest that credit spread should be regarded as constant and difference between the change in the interest rate for the liability and the change in risk-free rate should be treated as the change attributable to the price of credit risk. In other words, only the change in risk-free rate would be reflected in measurement of the liability. This is based on the concept that the liability should be discounted so as to reflect only the level of interest rate considering difference in the timing of payment and then simply wound up according to passage of time until the fulfillment of the liability, rather than excluding the portion attributable to credit risk.

(Question 4)

8. Our view is close to the alternative (c) of the three alternatives shown in paragraph 62 of the Staff Paper.
   a) As mentioned in the response to Question 1 (paragraph 4 of this comment letter), credit risk should be included in measurement of liabilities which are exchanged for cash at initial recognition or whose contractual cash flows include interest charged on the principal.
   b) Even when current measurement is necessary, inclusion of credit risk in measurement of liabilities would be generally inappropriate, as mentioned in the response to Question 2 (paragraph 6 of this comment letter).
   c) Even if a liability is to be measured at present value, only the change in risk-free rate should be reflected, as mentioned in Question 3 (paragraph 7 of this comment letter). However, whether the change in the measure reflecting only the change in risk-free rate should be recognised in profit or loss as in Example 4 is a matter that should be separately considered. There can be an alternative to treat such a change as a change in estimates because risk-free as well as future cash flows is a factor of estimates in determining present value.

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We expect that our comments contribute to the forthcoming deliberations in the project.

Yours sincerely,

Atsu Kato
Chairman of the Technical Committee for Financial Instruments
Board member of the Accounting Standards Board of Japan