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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir or Madame,

Comments on the Exposure Draft "Financial Instruments: Classification and Measurement"

We appreciate the efforts of the International Accounting Standards Board (IASB) on the financial instruments project and welcome the opportunity to comment on the Exposure Draft "Financial Instruments: Classification and Measurement" (hereinafter referred to as the "ED"). The views described below are those of the Financial Instruments Technical Committee, which has been set up within the Accounting Standards Board of Japan.

General Comments

(1) We generally agree with the proposed classification approach based on the business model of the entity because it makes clear that the forecast of future cash flow would depend on how business is conducted even if financial instruments have the same contract terms or they are in the same form and it would provide useful information for investment decisions. (see Question 1, paragraph 1)

(2) We are of the view that it is reasonable to provide an option to present changes in fair value of some investments in other comprehensive income (hereinafter referred to as "OCI") each period, because increase in the value of those investments is not the primary purpose of the investment. (see Questions 10 and 11, paragraph 26)

(3) The ED proposes that, regarding such investments opted for OCI presentation, fair value changes should not be subsequently transferred ("recycled") to profit or loss (net income). However, since the relationship between gains or losses presented in OCI and their recycling is a significant cross-cutting issue related to profit or loss, it should not be treated in developing individual accounting treatments for financial instruments on piecemeal basis, but should comprehensively be discussed in the project of Financial Statement Presentation or in a separate project in the near future.

Profit or loss represents entity's performance and, when accompanied by comprehensive income, it would provide useful information, so we are of the view that, with respect to financial instruments with changes in fair value through OCI, gains or losses on disposal, impairment losses, and dividends received should be recognized in profit or loss with recycling. (see Questions 10 and 11, paragraphs 27 and 28)

(4) In addition, we are of the view that fair value with regard to investments in equity instruments that has no quoted market price and whose fair value cannot reliably be measured does not provide decision useful information. (see Question 9, paragraphs 16-20 and 22-25)

(5) In many cases, reliable fair value is an appropriate measurement base for financial instruments. However, the ED does not give sufficient reasoning of why including fair value change in profit or loss, which represents total performance indicator, is essential to provide decision useful information. We are of the view that it is necessary to include explanation on what should be included in profit or loss, not from the perspective of the form of investment, and if such items are included, why users of financial statements can obtain decision useful information. (see Question 8, paragraph 21)

(6) The classification and measurement is related to impairment and hedge accounting. For example, application of the amortized cost basis is connected to impairment. Fair value option and the OCI presentation are related to how hedge is accounted for. We understand that the IASB has separated the Financial Instruments Project into phases and deal with the classification and measurement phase first as one of the urgent measures to address recent financial crisis, but the IASB should take care to avoid inconsistency between the outcome of this phase and future outcomes of impairment and hedge accounting phases. (see Question 5, paragraph 10, and Other comments, paragraphs 35 and 36)

(7) This project is one of the items in the MoU with the US Financial Accounting Standards Board (FASB). We recommend that the project be undertaken so that it promotes global convergence in an early stage, which would include addressing the issues we raise in this comment letter.

Comments on Questions

Our comments on the questions which are set out in the ED are provided below.

Classification approach (paragraphs 3-5 of the ED)

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional
guidance would you propose and why?

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate? if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?

(c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

Question 1

1. As stated in the paragraph BC17 of the ED, we believe that amortized cost can provide useful information when the instrument produces predictable returns based on its contractual terms and is managed on the basis of the contractual cash flows generated if it is held rather than sold or transferred. Accordingly, we are generally of the view that two proposed conditions for amortized cost basis are reasonable.
2. However, as stated in the comments to Question 2, we are of the view that sufficient guidance is necessary to clarify the scope of instruments accounted for as amortized cost.

Question 2

3. One of the conditions is that an instrument has basic loan features and these features are "contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding" (paragraph B1 of the ED). However, there are some ambiguities or discrepancies between this statement and illustration or guidance in the ED. Principle should be clearer and illustration and guidance should be consistent with that principle.
4. Here are some examples of ambiguities and differences we find in the ED.
    - Paragraph B3 of the ED gives an illustration using return, but the ED does not explain what the "return" is.
    - The ED does not explain how to judge "leverage". While paragraph BC21 of the ED explains that instruments with no funded amount have leverage, paragraph BC27 of the

ED explains that instruments with actual funded amount has leverage. But, according to paragraph BC26 of the ED, in the case of the instruments with actual funded amount, subordination due to the ranking of an entity's creditors does not give rise to leverage. Therefore, it is not clear an entity should compare an instrument with what kind of instruments or contractual terms when judging leverage.

- The accounting treatment is different by the nature of subordination (paragraph BC25 of the ED). That is,

  (a) An instrument that is subordinated to other instruments may still have basic loan features if the issuer's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest even in the event of the issuer's bankruptcy (paragraph B6 of the ED). On the other hand,

  (b) A tranche that provides credit protection to other tranches does not have basic loan features (paragraph B8 of the ED).

  Paragraph BC27 of the ED states that (b) does not have basic loan features because it is leveraged and "some tranches receive a higher return because they provide credit protection to other tranches" (paragraphs B8 and BC27 of the ED). However, subordinated loan in the case of (a) also provides credit protection to other credits in the same way as the subordinated tranche issued by structured investment vehicles provides credit protection to other tranches and, accordingly, the return of such a tranche which reflects credit risk has also the nature of interest.

- While paragraph BC29 of the ED states that a financial asset that is acquired at a discount that reflects incurred credit losses does not have basic loan features, paragraph B13 states that such an instrument is one of examples of instruments that are not managed on a contractual yield basis and there is no statement related to basic loan features in the standard itself. Thus, the reasons that such an instrument is not accounted for as amortized cost are not consistent in the ED.

5. Another condition for amortized cost basis is that an instrument is managed on a contractual yield basis. There are cases when financial instruments are managed not only on a contractual yield basis like in paragraph B9 but also are managed on fair value basis and their performance is evaluated on both accrual and fair value basis. On these occasions it may be difficult to judge whether the case in question meets this condition. Paragraph B10 of the ED states that this condition is not an instrument-by-instrument approach to classification because whether the condition is met does not depend on management's intentions for an individual instrument and paragraphs BC31 and BC32 of the ED makes clear that this approach is based on an entity's business model and is not a choice but rather it is a matter of fact. Especially, in paragraph BC33 of the ED, sales or transfers of financial instruments with basic loan features before

maturity would not change the business model of an entity, as long as such transactions are consistent with managing the collection or payment of contractual cash flows rather than realizing changes in fair values. Illustration should be provided to explain situations in practice where this statement applies.

Question 3

No comment.

Embedded derivatives (paragraphs 6-8 of the ED)

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

Question 4(a)

6. There may be cases when applying the proposed classification approach to an entire hybrid contract is problematic. For example, if the entire hybrid contract whose host is a financial liability is remeasured at fair value, it would result in including credit risk of the issuer in fair value of that financial host.
7. Accordingly, if the host is a financial liability, we are of the view that an embedded derivative should be separated from its host with two proposed conditions for amortized cost ((a) the host has basic loan features and (b) the host is managed on a contractually yield basis.).

Question 4(b)

8. We do not agree with the proposed application that only the most senior tranche has basic loan features and is eligible for amortized cost measurement, because other tranches in the waterfall structure may have credit risk in comparable level to normal corporate bonds (see paragraph 4 of this letter).
9. The problem is how to establish a threshold. One possibility may be to set criteria related to yield of assets held in the investment vehicle which has waterfall structure. Considering

statements in paragraphs B1, B3, BC20, and BC21 of the ED, another possibility may be to determine whether such an instrument is exposed to significant variability of entire actual cash flow through the collection of interest and principal as well as to clarify the meaning of variability of cash flow.

Fair value option (paragraph 9 of the ED)

Question 5 Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why? **Question 6** Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

Question 5

10. Regarding the fair value option based on the eligibility criterion of eliminating or reducing an accounting mismatch, its fundamental concept is the same as that of fair value hedge accounting. This fair value option should be reconsidered with hedge accounting and possible integration of these two accounting should be discussed.

Question 6

11. It is not necessary to retain the eligibility criterion regarding evaluation and management of performance on fair value basis.
12. It may be necessary to retain the eligibility criterion for financial hybrid contracts if an embedded derivative must be separated from its host in some cases.

Reclassification (paragraph 10 of the ED)

Question 7 Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

Question 7

13. The necessity of reclassification should be discussed considering the balance between the

relevance of information provided by classifications reflecting entity's business model and the reliability of such information (i.e. the exclusion of arbitrariness).

14. The ED proposes to prohibit reclassification entirely from the perspective of ensuring the reliability of financial reporting and mitigating complexity of the application of the standard, as stated in paragraphs BC57-59 of the ED.
15. However, since the ED proposes to classify a financial instrument as fair value category or as amortized cost category, not by management intent to an individual instrument, but on the factual basis of the "business model", an entity has no other choice but to change the classification of its instruments when it significantly changes its business model (see paragraph AV15 of the ED). The ED states allowing or requiring reclassifications would not make it easier for users of financial statements to understand the information that financial statements provide about financial instruments. However, users might be misled if the entity still continues to provide information that does not reflect the reclassification even after the entity converts its business model.

Investments in equity instruments that do not have a quoted market price and whose fair value cannot reliably measured

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

<u>Question 8</u>

16. We think that there are some cases when investments in equity instruments do not have quoted market prices and their fair value cannot reliably be measured. In those cases we are of the view that fair value measurement of investments in equity instruments does not provide decision-useful information.
17. Paragraph BC63 of the ED states that fair value provides the most relevant information to users. However, this does not apply when the fair value is not reliable. Rather, such measurement may mislead users of financial statements (see paragraphs BC11-12). It may probably be more so especially in the case of investments in equity instruments, whose cash flow is not contractually fixed or determinable. Cost basis as in the existing requirement may not be the best choice but it

disciplines too optimistic estimates.

18. In addition, even if an instrument is measured at cost, part of increase in the value of investments would be recognized in profit or loss through dividends received. So, cost measurement cannot completely be denied.
19. When entity's investment does not achieve its objective, the entity reflects the decline in the profitability of such investment through impairment[1]. Paragraph BC65 of the ED notes that, although there might be increased complexity in determining the fair value of the equity investment, that complexity would be offset by eliminating the requirement to monitor it for impairment. However, we are of the view that the fair value measurement would give rise to a problem as mentioned before in the case of investment in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured.
20. Paragraph BC66 of the ED notes that valuation methodologies for equity investments are well-developed. However, valuation of equity investments essentially includes the uncertainty of the outcome of the business invested, so we think in many cases it is difficult to make an estimate reliable enough to imitate a transaction price. As pointed out in FCAG report, effective financial reporting depends on high quality accounting standards as well as the consistent and faithful application and rigorous independent audit and enforcement of those standards (Principle 1: Effective Financial Reporting).
21. We think that reliable fair value provides relevant information as stock information and that it provides useful information if it is presented together with profit or loss which represents a performance indicator. Consequently, it is reasonable to provide option to present change of fair value in OCI instead of including such change directly in profit or loss each period (see paragraph 26 of this comment letter). In this connection, however, for instruments other than those elected for this OCI presentation, the ED requires entities to include change in fair value in profit or loss and the ED does not give sufficient reasoning why including such change in profit or loss which represents a total performance indicator provides decision-useful information. The final standard should explain what should be included in profit or loss and why that would make information decision-useful and such explanation should not stick to the form of investment such as financial instruments.

Question 9

22. We are of the view that the benefits of improved decision-usefulness generally do not outweigh the costs of providing this information when it comes to investments in equity instruments that

[1] Paragraph BC64 of the ED notes some criticisms such that the impairment in IAS 39 is based on a calculation that is similar to a fair value determination and that the calculation is no more reliable than measuring the equity investment at fair value. However, since the ED discusses classification based on business model, it may be appropriate to use value in use for impairment as in the case of fixed assets.

do not have quoted market price and whose fair value cannot reliably be measured.

23. As mentioned in paragraphs 16 and 17 of this comment letter, fair value of investments in equity instruments whose fair value cannot reliably be measured does not provide decision-useful information.

24. Moreover, fair value measurement increases costs for obtaining necessary information to apply valuation methodology, costs for actual implementation, and time and effort for communication with auditors and investors. Even in the case of impairment loss calculation required under existing IAS 39 paragraph 66, it seems not easy for general shareholders to obtain basic evidence for cash flow estimates such as business plans. It seems still more difficult for them to obtain necessary evidence for fair value measurement each accounting period.

25. Paragraph BC65 of the ED notes that the increased complexity in determining fair value would be offset by eliminating the requirement to monitor the equity investment for impairment. However, we think the cost for monitoring would be far below that for determining fair value because entities normally do not perform rigorous measurement in monitoring.

Investments in equity instruments that are measured at fair value through other comprehensive income (paragraph 21 and 22 of the ED)

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

<u>Questions 10 and 11</u>

26. Some investments are held not primarily to generate increases in the value of the investment. If changes in fair value of such investments are included in profit or loss each period, such profit or loss might not represent entity's performance. Therefore, we are of the view that it is reasonable to provide choice of OCI presentation.

27. Furthermore, the ED proposes that, regarding such investments opted for OCI presentation, fair

value changes should not be subsequently transferred ("recycled") to profit or loss. The relationship between gains and losses included in OCI and their recycling is a significant cross-cutting issue regarding profit or loss, so this proposed treatment should not be determined in developing individual accounting treatments for financial instruments on piecemeal basis, but should comprehensively be discussed in the Financial Statement Presentation project or in a separate project in the near future. Until then, the existing treatment should be retained.

28. In this regard, profit or loss represents entity's performance and, accompanied by comprehensive income, which is a change in net assets for a period, and by fair value, which is stock information, it provides useful information. Since many users of financial statements in our country support presentation of profit or loss and comprehensive income, we think that existing presentation of both incomes in financial statements is reasonable. These two indicators are independent and if they are presented in the same income statement, the adjustment (i.e. recycling) would be necessary as a matter of procedure. Therefore, regarding investments elected for OCI presentation gains or losses on disposal, impairment losses, and dividend received should be recognized in profit or loss.

Effective date and transition (paragraphs 23-33 of the ED)

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

<u>Questions 12 and 13</u>

No comment.

An alternative approach

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

(a) in the statement of financial position?

(b) in the statement of comprehensive income?

If so, why?

<u>Question 14</u>

29. Regarding financial instruments which have quoted price in an active market, an entity is likely to have more opportunities for sale as compared to loans and receivables. Therefore, we are of the view that their fair value information presented in the statement of financial position has some usefulness. In addition, we agree that part of the proposed treatment in the statement of comprehensive income has some merits because the sale of such instruments is constrained and it is not appropriate to include fair value changes in profit or loss which represents entity's performance.
30. The proposed treatment assumes recycling when impairment and no recycling in other situations. However, the reason of this difference is not clear in the ED. We consider profit or loss to be what is commented in Questions 10 and 11, so there is no need to make difference in the treatment between impairment and other situations. We are of the view that recycling should be maintained for the moment. (as stated in paragraph 27 of this comment letter, the issue related to recycling should comprehensively be discussed in the Financial Statement Presentation project or in a possible separate project from that project in the near future.)

Question 15
Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

<u>Question 15</u>

31. The first variant, which requires fair value changes of some instruments other than loans and receivables in profit or loss, is close to full fair value accounting. Unlike the alternative approach in Question 14, this variant does not provide disaggregated profit or loss information which is useful to predict future cash flow. Therefore, we do not agree with this variant.
32. The second variant requires all financial instruments including loans and receivables to be presented at fair value in the statement of financial position and, regarding instruments which have basic loan features and are managed on a contractually yield basis, disaggregated information would be presented in the statement of comprehensive income. We imagine that some IASB members may think this approach would provide decision-useful information to users. However, regarding loans and receivables, even though their fair value information is to be disclosed in the footnote, cost for preparation may not be small if early disclosure of preliminary figures is requested before completing one set of financial statements.
33. In addition, even if an instrument has basic loan features and is managed on a contractually yield basis, it may be sold. We disagree with no recycling in this case, too, for the same reason in the comment to Questions 10 and 11, which is the case of the investments in equity

instruments for OCI presentation,

Other comments

(Possible simplification)

34. We are aware that the IASB is making effort for fundamental changes and improvement to accounting standards for financial instruments, but we are concerned that it is difficult to gain constituents' sufficient acceptance for these fundamental changes in the short schedule. As another possibility, there might be improvement based on the existing requirements, for example, to establish an amortized cost category by including the held-to-maturity category in the loan and receivable category and to merge fair value option into hedge accounting. This would reduce the number of categories and has an advantage that transition from existing accounting is easy to understand.

(Implications on impairment)

35. The reason why accounting information based on amortized cost provides useful information is that the instrument produces predictable returns based on its contractual terms (paragraph BC17 of the ED) by allocating the interest income or interest expense over the relevant period using the effective interest rate. Consequently it is not the amortized cost itself but the income or expense in the allocation model that matters. The adjustment to recalculated carrying amounts when revising cash flow estimates using initial effective interest rate is recognized in profit or loss as income or expense as in paragraph B30 of the ED (catch up method)[2]. This may be because the IASB prefers to recognize return in profit or loss using initial effective interest rate. On the other hand, such revision of cash flow estimate is related to expected cash flow model which will be discussed in the context of impairment in the next phase. There are such issues as how often cash flow estimates should be revised[3], until what extent of decline of cash flow estimates entities can continue amortized cost basis[4]. The IASB should proceed with the classification and measurement phase taking into account such issues related to impairment.

(Implications on hedge accounting)

36. Paragraph 85 of IAS 39 states that hedge accounting recognizes the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item. The ED

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[2] In the context of IAS 8 prospective method (which revises effective interest rate and reflect such effect subsequently) would be appropriate. However, IAS 39 requires catch up method (paragraph AG8).

[3] It is difficult to claim that profit or loss which includes adjustments produces predictable return based on contractual terms if cash flows are revised each period.

[4] If entities apply amortized cost method based on expected cash flow approach to delinquent assets, which are exposed to significant variability of entire actual cash flow through collection of interest and principal, there is an issue whether entities should continue to recognize income or expense based on the initial effective interest rate. In addition there raises another issue that whether entities should discount revised cash flow estimates by initial effective interest rate when calculating amortized cost in the case that entities collect investment not on a contractual yield base but by selling the investment or collateral.

proposes that regarding the investment in equity instruments for OCI presentation amounts recognized in OCI are not subsequently transferred to profit or loss. Under this proposal, hedging activities for these investments would not be eligible for hedge accounting. Moreover, the nature of profit or loss would change from what it is today if requiring non-recycling. The IASB should consider whether it should still retain the existing objective of hedge accounting of presenting off-setting effect in the profit or loss.

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

Yours sincerely,

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