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ASBJ FASF

June 30, 2010

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

Dear Sir or Madame,

Comments on the Exposure Draft
"Financial Instruments: Amortised Cost and Impairment"

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: Amortised Cost and Impairment" (hereinafter referred to as the "ED"). The views described below are those of the Financial Instruments Technical Committee within the Accounting Standards Board of Japan.

General Comments

We support the objective of the "Amortised Cost and Impairment" phase of the IASB's Financial Instruments project that aims at improved measurement of amortised cost to provide more decision-useful information to users, particularly in transparency of provisions for losses on loans and the credit quality of financial assets.

We acknowledge the weakness of the current impairment model that recognition of credit losses might be belated.

In our view, the ED's proposal to reflect initially estimated credit losses in an effective interest rate is conceptually acceptable. However, we have concern about the proposal to require immediate recognition of the effect of changes in subsequently estimated credit losses in profit or loss through revising the estimate every reporting period.

Our primary concern is that measuring amortised cost as the present value of expected cash flows at all times would be inconsistent with the concept of adopting the measurement attribute distinct from fair value in the "Classification and Measurement" phase. We are also concerned about unresolved issues relating to the feasibility of the expected loss model proposed in the ED.

We suggest that the IASB consider an approach of recognising subsequent changes in credit losses based on the clarified indicators or triggering events, together with the treatment of reflecting initially estimated credit losses in an effective interest rate, to make recognition of credit losses earlier.

We hope that global convergence in this project, including issues we point out in this comment letter, will be sought as early as possible, since it is one of the items in the MoU with the US Financial Accounting Standards Board (FASB).

Comments on Questions

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

Objective of amortised cost measurement (paragraphs 3–5 of the ED)

Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

Question 1

1. The description of the objective of amortised cost measurement in the ED is clear.

Question 2

2. For financial assets held for earning interest, the objective of amortised cost set out in the ED is appropriate. However, our concern is that the objective of amortised cost measurement set out in the ED may not be appropriate for certain other financial assets. For example, the notion of effective return is less relevant for financial assets held for the purpose other than earning interest, such as trade receivables.

3. For financial assets such as trade receivables as mentioned above, we consider it necessary to include the description about their measurement objective, presentation and disclosure, corresponding to the practical expedients (shown in Questions 11 and 12) proposed in the ED.

Measurement principles (paragraphs 6–10 of the ED)

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasizes measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why?
How would you prefer the standard to be drafted instead, and why?

Question 4

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?
(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

Question 3

4. We suppose that the way the ED is drafted is a reflection of a criticism to existing IAS 39 that detail guidances on identification of loss events in the incurred loss model, including examples of loss events (paragraphs 59 and 60) and related application guidance (paragraphs AG89 and AG90), have caused diversity in interpretation and lack of comparability among different companies.

5. However, we consider the proposed impairment model needs minimum application guidance and examples to ensure that objective and comparable financial information is prepared. Our concern is that the application of the proposed impairment model, without further guidance, would be no less arbitrary and diverse than the current practice, given that it would involve significant management judgment to estimate expected cash flows.

6. In addition, further guidance or examples would be necessary for certain financial assets such as revolving loans and instruments with a combination of variable and fixed interest rates (e.g. a loan with an interest rate cap), because their treatment is not made sufficiently clear by the proposed measurement principles and application guidance.

Question 4(a)

7. In our view, the proposed approach that initially estimated credit losses should be reflected in determining an effective interest rate is conceptually acceptable (see paragraph 9). However, we have concern about another aspect of the proposed approach that the effect of changes in subsequently estimated credit losses should be immediately recognised in profit or loss through revising the estimate every reporting period (see paragraphs 10-13).

(Two elements of the credit losses under the proposed model)

8. Credit losses recognised under the proposed model can be divided into two elements:
   (a) initial estimate of credit losses reflected in the effective interest rate and allocated to each period over the life of the financial asset; and
   (b) subsequent changes in the estimates immediately recognised in profit or loss.

(The first element – allocation of initial estimate of credit losses)

9. We are of the view that the proposed treatment of the first element is conceptually acceptable, because the effective interest rate would include the initial estimate of credit loss and reflect the manner an entity determines the contract interest rate. Allocation of the initially estimated credit losses over the entire life of the instruments would provide more useful information about the effective rate. This approach is consistent with the entity's purpose of holding the instrument, that is, to collect its contractual cash flows rather than to sell it.

(The second element – subsequent recognition of the estimate in credit losses)

10. We suppose that the proposed treatment of the second element is an attempt to address the weakness of the current impairment model that recognition of credit losses may be belated. According to the view of IASB staff[1], one rationale for "catch-up approach" is that it would ensure that the amortised cost measured based on the proposed model would be always equal to the present value of expected cash flows discounted at the initial expected yield, including at initial recognition. We have the following concern about this, although some of our members supported the above rationale by the IASB staff.

11. First, a favorable change in estimated credit losses in earlier times might produce a counter-intuitive result that the amount of the gain to be immediately recognised exceeds the accumulated credit losses previously recognised. Such a consequence results from the inconsistency of the treatments of the second element with that of the first element, which would allocate the initially estimated credit losses over the remaining life of the financial assets.

12. Second, under the proposed treatment, there would be no strong reason for keeping the initial effective interest rate fixed as the discount rate, other than achieving cost-based measurement, because profit or loss for each reporting period would be determined as changes in cash flows and its present value during the period.

13. Lastly, the measurement principle of amortised cost proposed by the ED would result in creating an additional measurement attribute similar to fair value, in that the carrying amount

[1] IASB's Webcast Recording and Q&As on the project "Replacement of IAS 39"

would be determined based on the future cash flows estimated at each measurement date, except that a discount rate is fixed. Creation of such a measurement attribute was not at all discussed in the "Classification and Measurement" phase and it would undermine the basic concept consisted of two measurement categories (amortised cost and fair value). In addition, we are of the view that to reflect the recoverable amount in the carrying amount on an ongoing basis would fail to attain the objective of amortised cost proposed in the ED.

14. To address such concern, we considered two alternative approaches as below:

(Alternative 1: Allocation of estimated additional loss to entire period or remaining period)

15. One possible alternative approach, which addresses concern raised in paragraphs 11 and 12, would be to allocate the effect of changes in estimated credit losses over the initially estimated life of the financial instrument. Under this approach, the effect of changes in estimated credit losses would be divided into the amount attributable to the past period and to the future remaining period. The former would be immediately recognised in profit or loss and the latter would be recognised in profit or loss over the future remaining period. According to this approach, there would be no case of immediately recognising a gain in excess of the accumulated credit losses previously recognised (see paragraph 11) when there is a favorable change in estimated credit losses. However, taking account of practicability, there could be an approach of reflecting entire amount of revisions to estimates prospectively in a manner similar to the adjustment to depreciation of property, plant and equipment as required in IAS 8, rather than requiring retrospective adjustments to prior periods[2]. Accordingly, allocation of the revisions to expected losses over the remaining life of the financial asset would be consistent with the ordinary approaches of allocation.

16. There may be a criticism to this alternative approach that it would delay recognition of losses. Some members of us argued that this approach would delay the recognition of losses compared to the existing requirement, in cases of bad loans individually assessed for collectibility because of the triggering events under IAS 39.

(Alternative 2: Recognition of losses based on triggering events)

17. Another possible alternative approach, which addresses the concern raised in paragraph13, would be to retain the indicators or triggering events like the existing incurred loss model, together with the treatment of the first element in the ED. The ED criticizes the current

[2] For example, the effect of subsequent changes in expected losses could be allocated prospectively by resetting the effective interest rate based on re-estimated future cash flows.

incurred loss model for its systematic bias toward delayed recognition of losses (paragraph BC11(b) of the ED). Nevertheless, necessity of revisions to estimated credit losses on an ongoing basis would be reduced by the treatment of the first element that allocates the initially estimated credit losses to each period, because only the loss in excess of the initial estimate would be subsequently recognised. Accordingly, problems arising from retaining the triggering events would not be so significant.

18. The ED points out another criticism of the current incurred loss model that it is not necessarily clear when the loss event occurred and thus there have been significant diversity in practice. Such a criticism could be addressed by improving the current IAS 39 to clarify what are the triggering events so as not to generate diversity. Some preparers indicated that the proposed model requiring the estimate of future cash flows to be revised each period would generate more diversity than under the current practice. It seems that the ED focuses on justification for elimination of the triggering events and has not sufficiently considered the possibility of refining the triggering events. This point should be further considered utilizing an expertise of the Expert Advisory Panel.

19. We therefore suggest considering an approach of recognising subsequent changes in credit losses based on the clarified indicators or triggering events, together with the treatment of reflecting initially estimated credit losses in an effective interest rate so as to enable earlier recognition of credit losses, like our alternative approach 2[3].

(Practicability issue)

20. We acknowledge that the following practicability issues on the expected loss model, already pointed out in responses to "Request for Information" issued by the IASB in June 2009, are still significant concerns among preparers about the ED.
    - Difficulty of deriving estimates of expected cash flows over the life of the financial asset, which requires using historical data that might be difficult to obtain or not exist.
    - Challenges in incorporating expected credit losses in the calculation of the effective interest rate.

21. The proposed model in the ED, which requires keeping the initially determined effective interest rate fixed, generally seems to fit well to closed portfolios composed only of loans with

[3] The FASB's proposed Accounting Standards Update (ASU) issued in May 2010 proposes to remove the "probable" threshold for recognising credit impairments in the current incurred loss model. Such an approach can also lower the thresholds required to be crossed before recognizing any impairment losses (paragraph BC11(b) of the ED) and this might mitigate the weakness of the current incurred loss model that it has a systematic bias toward delayed recognition of losses as mentioned in paragraph 17.

similar dates of origination. However, many entities manage their assets on an open portfolio basis. We have concern that it would be difficult to apply the proposed model to those open portfolios.[4] Therefore, practical expedients would be necessary to address this concern.

22. Expected losses determined using a probability-weighted approach would be less likely to represent the actual losses for individual financial assets, than for large portfolios of homogeneous financial assets. An actual loss for an individual financial asset, in the case of default, would be much more than the initially expected loss determined as an expected value, and otherwise zero.

23. We support the setup of the Expert Advisory Panel to address some of the practicability issues related to the proposed impairment model.

Question 4(b)

No comment.

Objective of presentation and disclosure (paragraphs 11and 12 of the ED)

Question 5 (a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why? (b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

Question 5

24. The objective of presentation and disclosure in relation to financial instruments measured at amortised cost should be consistent with the objective of their measurement (see Questions 1 and 2). Accordingly, we are of the view that the objective of presentation and disclosure set out in the ED would be appropriate for financial assets held for earning interest revenue, such as loans, but not necessarily appropriate for other financial assets such as trade receivables (see our comments to Question 2, paragraphs 2 and 3).

[4] In a case of revising expected losses on those open portfolios, it would be difficult to determine whether the change results from the old loans which were already in the portfolio or the new loans added since the previous estimate. Under the proposed measurement principles, the portion of the former would be immediately recognised in gains or losses and that of the latter would be allocated over the estimated remaining periods.

Presentation (paragraph 13 of the ED)

Question 6 Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

Question 6

25. As stated in paragraph 25, with regard to financial assets held for earning interest revenue, we agree with the proposed presentation requirement for the following reasons:
   (a) Considering the objective of amortised cost measurement set out in paragraph 3 of the ED, interest revenue to be presented should be net interest revenue after adjusting the effect of allocated credit losses.
   (b) Interest margin is utilized by users of financial statements as an important business analysis indicator, which is determined as difference between the yield on a financial asset and the funding cost of a financial liability corresponding to that, based on the contractual interest rate. Therefore, it is still useful to present interest revenue based on the contractual interest rate in addition to net amount after adjusting the expected losses.
   (c) Furthermore, the proposed requirements would provide separate presentation of the effects of allocation of the initial estimate of expected loss over the remaining life of the instruments and those of subsequent changes in the estimates.

26. However, the proposed presentation requirements would be inappropriate for short-tem financial instruments such as trade receivables. In particular, when the practical expedients (see Questions 11 and 12) are applied, the presentation requirements corresponding to that would be needed because profit or loss would be affected mainly by revisions to estimated credit losses on subsequent measurement.

Disclosure (paragraphs 14–22 of the ED))

Question 7 (a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why? (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

Question 7(a)

27. We agree with the proposed disclosure requirements, except for the points mentioned in paragraphs 29 and 30 below. Under the proposed impairment approach, management judgment

would significantly affect the estimates of expected cash flows at each measurement date. Accordingly, the amount of amortised cost determined by the proposed approach would help users to compare the quality of credit losses of different companies, when disclosed together with the information about the method of estimates and assumption used to determine it.

28. However, requiring all of the proposed disclosures would not be necessarily appropriate from a viewpoint of cost-benefit and the final standard should clarify that disclosures may be simplified according to the entity's circumstances. In particular, for non-financial entities whose financial assets are mostly trade receivables, benefits from the proposed disclosures would not justify the costs to be borne by the preparers, in many circumstances.

29. The ED (paragraph 19) proposes to require the disclosure of a comparison between the development of the credit loss allowance over time and cumulative write-offs (the so-called "loss triangle") in a tabular format. It is our understanding that the IASB has decided to require this disclosure to enhance the disclosure about estimates of allowances for credit losses, after the manner of the disclosure of actual claims compared with previous estimates as required in IFRS 4 to provide information about difficult estimates. Some users strongly support the proposal arguing that this disclosure would provide a good insight into the level of precision of difficult estimates by comparing estimates of credit losses with actual write-offs. However, in our view, comparison according to the period of origination would be less meaningful for loans than for insurance contracts, given that there often exist more than one loans to a single debtor originated in different periods and turnovers of loans are more frequent. Furthermore, under the expected loss model reflecting the economic condition at each date, a simple comparison according to the period of origination might be misleading. If the information for comparisons is to be provided, an alternative idea would be to indicate a trend by disclosing comparison of data for several years.

30. The ED also proposes to require an entity to disclose the information related to stress testing, if the entity prepares stress testing information for internal risk management purposes (paragraph 20). Some preparers, opposing to the proposal, pointed out that (a) stress testing information is a kind of forecast and may be less reliable because the assumptions used to prepare it may vary widely among entities and (b) there is concern that the disclosure being provided only by some entities would undermine comparability among entities. Although we acknowledge that some users strongly support the disclosure of stress testing information, we believe that reconsideration is necessary about where to display such information, including the possibility of disclosing it in materials such as management commentary outside financial statements.

Question 7(b)

No comment.

Effective date and transition (paragraphs 23–29 of the ED)

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

Question 9

(a) Do you agree with the proposed transition requirements? If not, why?
What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

Question 10

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

Questions 8

31. Necessary lead-time would vary with circumstances of entities and the opinions of preparers need be taken into consideration. The extent of works and lead-time necessary for reconstruction of operation systems would vary according to the conditions of the entity's existing information system. In particular, for financial institutions holding substantial amounts of long-term loans, it would take no less than three years to accumulate necessary data and reconstruct the information system.

Questions 9 and 10

No comments.

Practical expedients (paragraphs B15–B17 of the ED)

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What

would you propose instead and why?

Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

Questions 11

32. We support the ED's proposal to allow an entity to use the practical expedients in certain circumstances, because applying the proposed impairment model would involve practicability issues for many entities, as mentioned in paragraph 21 above.

33. Clarification is necessary about when overall effect of practical expedients is considered immaterial and thus an entity may use them (paragraph B15 of the ED).

34. The principles to be followed by the practical expedients should be relaxed in order to allow an entity to adopt a measurement principle reflecting its economic reality, provided that their overall effect is immaterial. For example, calculating the present value of a financial instrument by estimating all of its cash flows over its entire remaining life and their timing would be unduly burdensome to preparers, while the usefulness of the resulting information is relatively low.

35. In addition, as mentioned in paragraph 27 above, the presentation and disclosure requirements need to include those corresponding to the practical expedients, if they are used.

Questions 12

No comment.

Other comments

(Convergence with the FASB)

36. We are aware that when the IASB determined to establish two measurement categories (amortised cost and fair value) in the "Classification and Measurement" phase there was discussion that the difference between the IASB's proposal and the FASB's tentative decisions, in which an entity would measure most financial assets at fair value, would be reconciled by the treatments, such as (a) under the IFRS, an entity would present the amortised cost of the financial assets on the face of the statement of financial position and disclose their fair value in

the notes and (b) under the US-GAAP, an entity would present on the face of the statement of financial position the amortised cost, the allowance for credit losses for the financial assets, and the accumulated amount needed to reconcile amortised cost less allowance for credit losses to fair value on those instruments in addition to measuring them at fair value.

37. However, the amortised cost measurement of the ED is based on the effective interest rate including the initial estimate of credit loss (paragraph 9), which is different from the amortised cost measurement proposed by the FASB. Accordingly, we acknowledge that the initially designed reconciliation would not be fully achieved by the treatments mentioned in paragraph 36.

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

Yours sincerely,

Atsushi Kato
Chairman of the Financial Instruments Technical Committee
Vice Chairman of the Accounting Standards Board of Japan