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ASBJ FASF

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Technical Director
File Reference No. 1810-100
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Dear Sirs/Madams,

Comment on the Proposed Accounting Standards Update "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities"

We appreciate the FASB's efforts to improve the accounting for financial instruments and welcome the opportunity to comment on the above Proposed Accounting Standards Update (hereinafter referred to as the "ED"). The views expressed in this letter are those of the Financial Instruments Technical Committee, which has been set up within the Accounting Standards Board of Japan.

We support a mixed measurement attribute system in which the measurement attribute reflects the entity's business activities. Under this system, the measurement attribute is determined in relation to the objective of holding the instruments or to the way an entity manages its instruments, which we think is essential for financial reporting to be useful. In this regard, we appreciate that the ED has taken into account the perspective of the business strategy when classifying financial instruments.

However, we are concerned that the ED would broaden the scope of instruments which would be measured at fair value. In our view, amortized cost is appropriate for certain instruments and, for those instruments, rather than measuring them at fair value with qualifying changes in fair value recognized in other comprehensive income, requiring only amortized cost on the balance sheet and requiring fair value information in the notes should be sufficient.

We acknowledge that the financial instruments project is one of the most important joint efforts between the FASB and the IASB. However, the proposals in the ED differ in several fundamental aspects from the requirements in IFRS 9 "Financial Instruments" and the proposals in the IASB's exposure draft "Financial Instruments: Amortised Cost and Impairment." In addition, while the ED

has proposed improvements to current hedge accounting, the IASB's current discussion is not necessarily in line with these proposals. Accordingly, we urge the Boards to continue their efforts toward developing a converged solution.

Finally, we are concerned about the proposal that all investments in equity instruments be treated in the same manner as fair value through net income (FV-NI) because the proposal might not represent the economic substance of some investments. We urge the FASB to continue to discuss how to account for investments in equity instruments, taking into account the exceptional treatment to FV-NI in IFRS 9 which has been provided to deal with such an issue.

We have provided responses to several specific questions raised in the ED in the appendix to this comment letter.

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

Yours sincerely,

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

Appendix: Responses to specific questions

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

1. We note that this response relates to financial assets. For financial liabilities, please refer to our response to Question 15.
2. Although we acknowledge there is an argument that fair value information presented on the face of the financial statements is generally of higher quality compared to such information presented in the note disclosures, we do not agree with the proposal that the default measurement attribute for financial assets should be fair value. If the entity's business strategy is to collect the contractual cash flows rather than to sell the financial asset, amortized cost measurement and its resulting profit or loss information better represents the entity's business strategy for holding the asset. Therefore, we believe that an entity should apply amortized cost if certain criteria, including when the entity's business strategy is to collect the contractual cash flows rather than to sell the financial asset, are met.
3. We are aware that the FASB provides the FV-OCI category for cases mentioned in the preceding paragraph. The accounting treatment for this category is similar to "available-for-sale" securities (AFS securities) and, thus, the category is confusing to users to understand the entity's ordinary business strategy. While entities are expected to hold FV-OCI instruments for a significant portion of their contractual terms, no such condition exists for AFS securities. Thus, the fair value information and resulting other comprehensive income similar to information provided for AFS securities may be taken to suggest that the instruments are held under a different business strategy from that of FV-OCI.
4. Currently entities usually disclose fair value information in the accompanying notes to their financial statements (FASB Accounting Standards Codification ™ 825-10-50-10). Users can obtain fair value information by looking at the information presented in the notes.

Question 15: Do you believe that the subsequent measurement principles should be the same for

financial assets and financial liabilities? If not, why?

5. We are of the view that subsequent measurement principles do not need to be the same for financial assets and financial liabilities.
6. Entities generally assume financial liabilities to pay their contractual cash flows. Unlike financial assets, financial liabilities are rarely transferred except when businesses are transferred. A transfer of a financial liability usually requires the permission of the counterparty, and some liabilities cannot be transferred in any practical way. Accordingly, we are of the view that financial liabilities with fixed or slightly variable cash flows should not be remeasured. Fair value measurement should be limited only to financial liabilities held for trading and derivative instruments.
7. In addition, the FASB's proposal includes exceptions specific to financial liabilities, which may suggest that financial liabilities have different characteristics from financial assets that should be taken into account when determining the measurement attribute.
8. Regarding the treatment of hybrid instruments, it seems reasonable to retain the bifurcation of embedded derivatives if we are to emphasize the issue on the presentation of entity's own credit risk.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

9. According to the ED, an entity would initially be given a choice of measurement attributes under certain conditions. For example, a financial instrument is not "required" to but "may" be classified as FV-OCI if it meets certain criteria. This optional feature also appears in the amortized cost measurement for financial liabilities. Prohibition of reclassification seems to be conceptually consistent with this optional feature.
10. We are, however, of the view that an entity basically should not be provided with an option to determine the measurement attributes. Financial statements should reflect the entity's business strategy or how the instrument is managed. Also, the ED's criteria articulate the situations in which the effective interest rate method is suitable. Therefore, in our view, reclassification should be required when an entity changes its business strategy.

11. The same may apply to financial liabilities, but the prohibition of reclassification might not be a significant problem if fair value measurement is limited only to instruments mentioned in our response to Question 15.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

12. We understand the constituents' view that core deposits often are the primary source of value for a financial institution. However, we do not agree with the remeasurement of the core deposit liabilities. In our view, the proposed approach does not seem to be the only approach for estimating the benefit of core deposit liabilities, and it is not necessarily a familiar method for those not involved in M&A practice. In addition, it would invite complexity by introducing a measurement attribute that is different from fair value or amortized cost.
13. We rather prefer that the FASB proposes to disclose information related to the benefit of core deposit liabilities in the accompanying notes or outside the financial statements instead of requiring core deposit liabilities to be remeasured at present value based on the implied maturity, provided that the IASB also follows the same direction. In this case, we prefer disclosing the information necessary for users to calculate a rough estimate of the benefit of core deposit liabilities according to the M&A practice, rather than to disclose the calculated amount of the benefit of core deposit liabilities.
14. We also wonder whether this treatment would raise the issue of the accounting unit. The approach would apply to a portfolio of demand deposits by considering the average amount as core deposits, which is different from the usual accounting treatment of financial instruments that normally determines the measurement attribute on an individual instrument basis.

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

15. As mentioned earlier in our response to Question 15, we are of the view that the scope of instruments which should be measured at fair value should be limited to financial liabilities held for trading, and derivative liabilities. If the scope of instruments is limited as suggested, own credit risk should not be a significant problem.
16. For other financial liabilities, we generally agree with the tentative decision by the IASB, on the premise that the criteria for the fair value option remains as they are today. That is, we agree that most financial liabilities should be measured at amortized cost and that an entity recognizes changes in fair value attributable to entity's own credit risk in other comprehensive income if a financial liability is designated as fair value through profit or loss, because we are of the view that including such changes in net income would not provide useful information to users.
17. The ED's approach of separating changes in entity's credit standing and those in the price of credit is persuasive, but in many cases it seems practically difficult to separate them in the same way as in Appendix B of the ED.

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s).

The IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss.

Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

18. Under the proposed model, for financial assets evaluated on a collective basis, our understanding is that a credit impairment would generally be recognized in the period of the

origination of the assets based on historical experience corresponding to their contractual term and current conditions.

19. We believe that recognizing a loss on initial recognition of the financial asset for financial reporting purposes even though there has been no loss incurred from the asset would result in unfaithfully representing the underlying economic phenomenon.
20. Although we acknowledge the notion that financial assets often are priced assuming a certain amount of losses on the total pool even though the entity initially expects to collect all on each individual asset, we are of the view that such initially expected losses should be allocated to each period over the life of those financial assets. This approach is in line with the purpose of the business strategy for which an entity holds financial instruments for a significant portion of their contractual terms (that is, to collect the related contractual cash flows rather than to sell the financial assets).

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

21. As mentioned later in our response to Question 48, the measurement of the historical loss rate affects not only the amount of credit impairment but also the amount of interest income. Accordingly, we are of the view that, to ensure the comparability of credit impairment and interest income among entities, it would be necessary to incorporate in the final standard an additional guidance for determining historical loss rates.

Question 48: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

22. We are of the view that the method of interest income recognition shall be consistent with how the loans are evaluated for impairment, that is, whether they are evaluated on a present value technique basis or a historical loss rate basis.
23. Our understanding is that the method of recognizing interest income under the proposed model is consistent with the method of recognizing credit impairment on a present value technique basis. The present value technique, which takes into consideration expected interest cash

flows, results in a discounted present value of expected cash flows, which is equal to amortized cost after netting the allowance for credit losses. The amount of interest income shall be determined by applying the financial asset's effective interest rate to the amortized cost balance after netting the allowance for credit losses.

24. On the other hand, since the proposal does not specify a particular methodology for determining the historical loss rate (refer to our response to Question 40), that rate may be calculated based on the loss on the collection of the principal only, and not necessarily all cash flows. In such a case, we are of the view that the amount of interest income shall be determined by applying the financial asset's effective interest rate to the amortized cost balance (before netting the allowance for credit losses) and the amount of credit impairment shall be measured based on the change in the historical loss rate.

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

25. The highly effective criteria are currently causing problems in the application of hedge accounting, such as (a) an entity may not be able to apply hedge accounting consistently because, even though the hedging relationship is eligible for hedge accounting in one period, such relationship may not meet the highly effective criteria in the next period, and (b) an entity may avoid applying hedge accounting to a hedging relationship for its whole period that the entity believes is highly effective for fear of being unable to demonstrate that the hedging relationship meets the highly effective criteria in some reporting periods (as described in paragraph BC218 of the ED). We believe that modifying the effectiveness threshold from highly effective to reasonably effective would resolve those problems. This change would reduce complexity in the qualifications for hedge accounting, make it easier for entities to consistently apply hedge accounting, and maintain comparability and consistency in financial statements.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

26. The determination at the inception of a hedging relationship that the hedging relationship is expected to be reasonably effective over the expected hedge term is at best based on an entity's estimate. The entity does not prove that the hedging relationship will actually be reasonably effective over the expected hedge term. It is reasonable to say that there will be a difference in

the change in fair value and in cash flows between the hedged item and the hedging instrument, except when the hedged item is perfectly hedged using a hedging instrument that has the same risk profile as that of the hedged item. Therefore, we are of the view that, in some cases, an effectiveness evaluation would be required subsequently, even if it was determined at the inception that a hedging relationship was expected to be reasonable effective over the expected hedge term.