Accounting Standards Board of Japan (ASBJ)

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International Accounting Standards Board
30 Cannon Street
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Dear Sir/Madam,

Comments on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010))

We appreciate many years of efforts made by the International Accounting Standards Board (IASB) in the Financial Instruments Accounting project and welcome the opportunity to comment on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9 (2010))* (hereinafter referred to as the "ED"). The following views are those of the Financial Instruments Technical Committee within the Accounting Standards Board of Japan.

General Comments

1. We appreciate that the IASB and the US Financial Accounting Standards Board (FASB) (hereinafter collectively the "Boards") have worked together to reduce major differences in their respective classification and measurement models for financial instruments. We welcome that as a result of joint deliberations the Boards have taken steps toward convergence in major areas of the classification and measurement requirements. This is consistent with the Boards' objective to increase international comparability in the accounting for financial instruments.

2. We support the intention of the proposed limited amendments to IFRS 9 *Financial Instruments* to address specific application issues on IFRS 9 and the interaction between IFRS 9 and the Insurance Contracts project. The proposed amendments would further strengthen two principles of the business model and the contractual cash flow characteristics assessments in IFRS 9 to determine classifications of financial assets. In addition, they would provide more relevant information about the timing, amounts and uncertainty of an entity's future cash flows.

3. We support the ED's proposal to introduce the fair value through other comprehensive income (FVOCI) measurement category for some debt instruments because it would help properly present an entity's financial position at the reporting date and performance during the period. We

acknowledge that some may disagree with the introduction of the FVOCI measurement category in the light of simplification of the financial instruments accounting. However, we believe that the complexity of a standard does not solely depend on the number of measurement categories and the categorisation properly depicting an entity's business models is essential to useful financial reporting.

4. We support the ED's intention to reaffirm and clarify the existing principle in IFRS 9 for the contractual cash flow characteristics assessment. It would align the relevant criteria in IFRS 9 with the economic concept of principal and interest by clarifying that instruments with slightly specific features (that is, an interest rate mismatch or leverage) existing in the market norms may be consistent with the contractual cash flow characteristics assessment. However, we consider that there are some issues that should be further considered and issues for which there may be another possible alternative. The details are described in our comments on Questions 1 to 3.

5. We consider that implementation of IFRS 9 might become confusing for first-time adopters of IFRSs. Due to the interaction of the existence of multiple versions of IFRS 9 currently applicable before the mandatory effective date and the ED's proposal to prohibit their partial early application, a complex situation may arise that the versions of IFRS 9 available for first-time adopters would significantly differ depending on the timing of the transition to IFRSs. We hope the IASB to consider a way to avoid disruption to first-time adopters and to mitigate their burdens when discussing the transition to IFRS 9 for first-time adopters after the comment period of the ED.

6. Finally, we comment on necessity of bifurcation of hybrid financial assets as an additional issue although it is not included in the ED's proposals and questions. This is because it was an issue jointly deliberated by the Boards as one of the key areas. We believe that hybrid financial assets as well as hybrid financial liabilities should be bifurcated if certain criteria are met. Bifurcation would result in faithful representation of the economic that an item is composed of elements with different risk characteristics. From this point of view, a hybrid financial instrument should be treated equally irrespective of whether it is a financial asset or a financial liability.

Comments on specific questions

Our comments on questions set out in the ED are as follows:

Question 1

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that

this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

Question 2

Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Question 3

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

7. We agree with the ED's intention to clarify the existing principle in IFRS 9 by a minor amendment to the application guidance in IFRS 9 in order to address questions raised by constituents, reaffirming the principle that a financial asset may be measured at other than fair value through profit or loss (FVPL) if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest.

8. Such clarification would allow entities to take consideration of some market norms such as an interest rate mismatch and leverage in a particular market which may not be consistent with the economic concept of the time value of money and thus provide useful financial information through appropriate classification of financial assets.

9. However, we are of the view that there could be some improvements in the assessment of "a modified economic relationship" proposed in the ED and therefore we suggest as follows:

(Distinction from "materiality")

10. We acknowledge that the ED uses the term "insignificantly" intentionally to distinguish from the general notion of materiality. We also acknowledge that it was indicated that a modified economic relationship is assessed on a more generous level than the notion of materiality during the IASB's deliberation. However, the ED does not describe anything about that intention. We therefore suggest that such intention be clearly described in the application guidance in IFRS 9 so as to help its application in practice.

(Concerns arising from unclear concept of "a modified economic relationship")

11. Based on the ED's proposal, the contractual cash flow characteristics assessment is considered to

comprise the following processes:

(a) assess whether the contractual cash flows include payments that are unrelated to principal, the time value of money and the credit risk (hereinafter referred to as the “three components”). If payments unrelated to the three components are included, the financial asset would not meet the contractual cash flow characteristics criteria.

(b) if payments unrelated to the three components are not included, assess whether the economic relationship between the three components is modified.

(b-1) if the economic relationship is not modified, the financial asset would meet the contractual cash flow characteristics criteria.

(b-2) if the economic relationship is modified, assess whether the modification could result in cash flows that are more than insignificantly different from those of a benchmark instrument. If so, the financial asset would not meet the contractual cash flow characteristics criteria.

12. This assessment of a modified economic relationship was discussed at the February 2012 joint meeting held by the Boards. We acknowledge that at that meeting the Boards made tentative decisions based on the recommendation by the Boards’ staff. However, we have a concern about this methodology as noted below.

13. Paragraph BC4.25[1] of IFRS 9 appears to imply that the notion of materiality applies to the contractual cash flow characteristics assessment. In the light of this, although not clarified in the ED, there could be an interpretation that the process (a) in paragraph 11 above is assessed based on materiality and the process (b-2) is assessed by whether the difference is more than insignificant.

14. However, the ED does not explain the underlying concept of what a modified economic relationship is, although it refers to cases where an interest rate mismatch feature or leverage exists as examples. In interpreting the process (b-2) in paragraph 11, the modification of the economic relationship between the three components could be considered as meaning that the cash flows do not represent the time value of money or the credit risk. Therefore we find it difficult to conceptually distinguish “modified” in the process (b) from “unrelated to the three components” in the process (a).

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[1] Paragraph BC4.25 of the Basis for Conclusions on IFRS 9 states as follows:
“The Board decided to clarify how contractual cash flow characteristics should affect classification and improve the examples that illustrate how the condition should be applied. It decided not to add application guidance clarifying that the notion of materiality applies to this condition, because that notion applies to every item in the financial statements. However, it did add application guidance that a contractual cash flow characteristic does not affect the classification of a financial asset if it is ‘not genuine’.”

15. For the reason noted above, dividing the process of the contractual cash flow characteristics assessment into (a) and (b) above might complicate the assessment and seem inconsistent. In addition, it is not clear how to assess the characteristics if it is difficult to determine whether payments are unrelated to three components (for example, when contractual cash flows include fees charged to transactions[2]). Therefore, we would like the IASB to pay attention to the concern in the ED's proposal as we mentioned above and explore a better approach.

16. For example, a possible alternative[3] may be simplification by combining the processes (a) and (b) into one process to assess whether the contractual cash flows include payments unrelated to three components, instead of incorporating the assessment of a modified economic relationship and dividing the process into (a) and (b). In this case, an entity would determine whether the contractual cash flows include payments unrelated to principal, the time value of money and the credit risk by assessing whether the contractual cash flows could be more than insignificantly different from the benchmark cash flows[4].

(Specific methodology of the assessment of a modified economic relationship)

17. The ED proposes to require an entity to consider only reasonably possible scenarios rather than every possible scenario on the assessment of a modified economic relationship at initial recognition of a financial asset. However, the ED does not specify how to make such assessment.

18. We believe that application guidance in IFRS 9 should include illustration of specific methodologies for the assessment, and thereby we can expect to avoid confusion on implementation. Although what method to use may vary depending on the characteristics of instruments, possible methods would include comparison with benchmark cash flows separately for each reset period of interest rates and comparison with total benchmark cash flows throughout the entire contractual life of the financial asset.

(Paragraph BC44 of the ED)

19. We believe that in Japan there are not generally interest rates in regulated environments as noted in paragraph BC44 of the ED.

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[2] In some cases, interest may include fees and administrative cost charged to a transaction.

[3] We acknowledge that this alternative would have a drawback that, if a component other than the three components is assessed as insignificant, a financial asset including that component would be eligible for measurement categories other than FVPL, resulting in expanding the scope of the limited amendments to IFRS 9 beyond the feedback from constituents.

[4] In this case, there may be a concern that an entity would be required to compare all financial assets with benchmark instruments without exception. However, such a problem can be avoided by specifying that comparison with benchmark instruments would not be required if it is clear that the contractual cash flows of a financial asset do not include payments unrelated to the three components.

(Other issues which are not within the ED)

20. The following two issues are not within the scope of the ED, but we consider clarification of those aspects in the existing requirements of IFRS 9 is necessary in relation to the contractual cash flow characteristics assessment.

    (a) *The meaning of credit risk*: Among the three components, what credit risk means is not clear in some cases. Credit risk is defined as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation" in Appendix A of IFRS 7 *Financial Instruments: Disclosures*. We would like to confirm that credit risk potentially includes risk of loss depending on the success or failure of projects which generate cash flows as the resource for debtor's repayment (hereinafter referred to as "project risk[5]") and price risk of collateralised assets.

        Paragraph B4.1.16 of IFRS 9 indicates that when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a "non-recourse" financial asset), a financial asset may not meet the contractual cash flow characteristics criteria. We consider this might be interpreted as implying that risk of a loan attributable to project risk or price risk of collateralised assets is not credit risk[6].

        However, we consider that project risk or price risk of collateralised assets represent a debtor's credit risk, if the debtor repays the loan using cash flows from its business activity and the interest rate reflects higher risk owing to a non-recourse condition. Therefore, we would like to confirm that such project risk or price risk of collateralised assets included in a financial asset can be deemed as part of credit risk in assessing the contractual cash flow characteristics

    (b) *Treatment on a modification of contractual terms*: We believe it should be clarified whether the contractual cash flow characteristics need to be reassessed or not if contractual terms of a financial asset are subsequently modified, which neither the ED nor the current IFRS 9 specifies. For a financial liability, the current IFRS 9 clearly states that an entity is required to extinguish the original financial liability and recognise a new financial liability[7].

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[5] We take into account project risk inherent in a project finance used for large scale infrastructure improvements and development of resources. We acknowledge that a project finance loan often has a non-recourse condition.

[6] We acknowledge that paragraph B4.1.17 of IFRS 9 states that the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the contractual cash flow characteristics criteria.

[7] Paragraph 3.3.2 of IFRS 9 states that a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted

Therefore, we think that, if contractual terms of a financial asset are substantially modified, an entity should extinguish the original financial asset and recognise a new financial asset, rather than reassessing the contractual cash flow characteristics.

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:

(a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and

(b) all other gains and losses are recognised in OCI?

If not, why? What do you propose instead and why?

21. We agree with the ED's proposal to introduce the FVOCI category for eligible debt instruments.

22. The two measurement category model (amortised cost and FVPL) under the existing IFRS 9 may not always provide adequate depiction of a variety objectives of business models for holding debt instruments, such as collecting principal and interest, earning income through sales, preparing for liquidity needs, and managing interest rate risk. Those business model objectives often include both collecting the contractual cash flows through holding a financial asset and realising gains through sales. Introducing the FVOCI category would help appropriate presentation of an entity's financial position at the reporting date and performance during the period, by providing fair value information in the statement of financial position and amortised cost information in profit or loss. Therefore, we consider it appropriate to introduce the FVOCI category, which would enable financial statements to provide the information as mentioned above.

23. Furthermore, the two measurement category model involves practical tension between measurement categories. For example, accounting outcomes could significantly differ depending on how to interpret the phrase "an infrequent number of sales" under the existing IFRS 9. Introducing the FVOCI category would mitigate such practical tension.

24. We acknowledge that some may disagree with the introduction of the FVOCI measurement category. Those who disagree may argue that the two measurement category model should be retained because the primary objective of the development of the current IFRS 9 was to simplify

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for as an extinguishment of the original financial liability and the recognition of a new financial liability. Additionally, paragraph B3.3.6 of IFRS 9 states that for the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

the accounting standards for financial instruments. As described in paragraph BC21 of the Basis for Conclusions on the ED, although the IASB acknowledges that a third measurement category (FVOCI category) adds complexity to IFRS 9, it also notes that the complexity would be justified by the usefulness of the information provided by that category. We agree with this view of the IASB. We believe that the complexity of a standard does not solely depend on the number of measurement categories and that the categorisation properly depicting an entity's business models is essential to useful financial reporting. Therefore, as noted in paragraphs 22 and 23 of this comment letter, we consider that introducing the FVOCI category as proposed in the ED is appropriate.

25. We have been emphasising the importance of the notion of profit or loss and firmly believe that recycling of OCI is essential. The ED's proposal to require recycling of the FVOCI category for debt instruments is therefore consistent with our long-held view. However, we are aware, as noted in our comment letter on Request for Views "Agenda Consultation 2011", lack of consistency in the treatment of recycling (such as for equity instruments designated under the OCI option and financial liabilities designated under the fair value option) is one of important issues in IFRSs. Therefore, we hope the IASB to establish a fundamental concept of profit, including the nature of profit or loss, in the Conceptual Framework project.

Question 5

Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

26. We suggest clarifying and amending the proposed application guidance as shown below.

(Objective evidence relevant to assessing a business model)

27. Paragraph B4.1.2B of the ED sets out a list of objective evidence relevant to assessing an entity's business model, including how the performance of the business is reported to the entity's key management personnel and how managers of the business are compensated. However, descriptions in paragraphs B4.1.3 to B4.1.6 of the ED may not be sufficiently clear in determining what factors can provide the evidence of the business model. Although definitive distinction in the standard would be difficult, illustration of typical characteristics in a systematic manner as shown in the table below would highlight the differences between the business models and help judgment in the assessment.

	FVPL	FVOCI	Amortised cost
How to collect cash flows	Typically through sales	Both through sales and holding to collect contractual cash flows	Typically through holding to collect contractual cash flows
Reason for sales	Realisation of gains on sales	To respond to credit deterioration, realise gains on sales, meet everyday liquidity needs, match duration of liabilities	To respond to credit deterioration, meet liquidity needs in stress-scenario, meet unanticipated funding needs
Frequency of sales	Frequent	Depending on the situation (such as an entity's ALM position)	Infrequent in general (even frequent sales may be consistent if insignificant both individually and in total)
Volume of sales	Significant	Depending on the situation (such as an entity's ALM position)	Insignificant in general (even significant sales may be consistent if infrequent)
How performance of business is evaluated by and reported to an entity's key management personnel	Focus on FV in the main	Focus on both FV and interest income and credit quality	Focus on interest income and credit quality in the main (use of FV (if any) is only supplemental)
Time horizon when using FV	Short term	Medium and long term	Long term (if any)
How managers are compensated	More directly linked to FV	Linked to both FV and interest income and credit quality	More directly linked to interest income and credit quality (FV is not typically relevant)

(The meaning of "managed on a fair value basis")

28. Paragraph B4.1.6 of the ED states that a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor managed both to collect contractual cash flows and to sell assets (that is, consistent with the FVPL category). This wording is not a proposal to change the current IFRS 9 and we suppose that its intention is to ensure the consistency with the wording of the current fair value option requirement for a financial liability[8].

29. However, because an entity may monitor fair value of financial assets measured at FVOCI from the perspective of its risk management, the meaning of "managed and whose performance is evaluated on a fair value basis" should be clarified.

30. If the wording of paragraph B4.1.6 intends to address short-term profit-taking activity like holding for trading, we suggest adding explanations, for example, "a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis in order to mainly take short-tem profit may fall within the FVPL category", and "monitoring fair value of financial assets from the perspective of an entity's risk management does not necessarily mean that those assets fall within the FVPL category".

(Examples of reclassification)

31. Application guidance in the current IFRS 9 sets out only extreme examples for reclassification of financial assets such as acquiring a company and closing a business. Because paragraphs B4.1.2A and B4.1.2B of the ED propose to add several examples of objective evidence for determination of the business model, causes of changes in the business models would include how to manage the business, how to report the performance of the business and how to compensate managers of the business. Therefore, adding examples of changes in business models due to changes in how the business is managed or other changes (and therefore the reclassification) would help constituents' better understanding. However, the concept in the current IFRS 9 that a change in business model resulting in the reclassification is expected to be very infrequent should be retained even if the number of measurement categories increases to three.

(Reclassification date)

32. Although the issue of reclassification date is not addressed in the ED, we comment on reclassification date, given that we did not have an opportunity to formally provide our comments

[8] Paragraph 4.2.2(b) of IFRS 9 which requires a fair value option for a financial liability states that "a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, […]"

about it and the FASB has recently proposed a different treatment.

33. Under IFRS 9, the reclassification date is defined as the first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets, whereas the FASB proposes that the reclassification date is the last day of the reporting period in which an entity's business model changes. Unlike those, we suggest that the reclassification date should be the date on which the business model changes.

34. One reason for our suggestion is that, if an entity is required to reclassify financial assets at a timing different from that of the change in business model, as in the requirement by the IASB or the FASB, the entity would have to continue until the reclassification date the accounting treatment which no longer faithfully represents the business model in which those assets are managed. This might provide users with misleading information. Additionally, the timing when the change in business model is reflected in the financial statements would be different depending on the frequency of interim reporting (eg, quarterly reporting).

35. We understand that the Boards are concerned about the possible arbitrary choice of the date of the change in business model. This concern relates to how restrictive the change in business model should be. Under both the current requirements in IFRS 9 and the FASB's proposal, a change in business model is expected to be very infrequent. It must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Disclosures are also required to ensure transparency. We believe that the concern about arbitrary choice could be addressed by incorporating mechanics to objectively determine the timing of the change in business model, in addition to the guidance and disclosures noted above.

(Timing of changes in business model)

36. As noted in the preceding paragraph, a change in business model is expected to be very infrequent. However, there still remain ambiguities about when such a change in business model takes place. There could be some potential alternatives of the timing of the change in business model:

    (a) At the time when an entity's senior management decides to change its business model. Related changes in operations may occur in the same period or in the future period.

    (b) At the time when a new organisation or system under the new business model actually starts to operate according to the decision described in (a) above.

    (c) At the time when a new transaction is actually initiated under the new business model.

37. It may not be appropriate to deem (a) as the timing of the change in business model because the

accounting treatment might not reflect the reality of a financial asset still managed within the previous business model, depending on the timing of the decision-making.

38. On the other hand, deeming (c) as the timing of the change in business model also may be inappropriate, because once a new organisation or system has started to operate, existing assets and liabilities are already managed based on the new business model regardless of whether a new transaction is actually initiated.

39. Consequently, we believe that (b) would usually be the appropriate timing of the change in business model. Anyway the timing should be determined by taking account of all relevant facts and circumstances and there may be some cases where timing other than (b) is considered reasonable depending on the facts and circumstances. However, we believe that, at least, an entity should clearly state the timing of the change in business model in its documentation of such decision-making.

Question 6

Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

40. We agree with the ED's proposal. For financial assets, the existing fair value option in IFRS 9 intends to mitigate an accounting mismatch that results from the different measurement attributes used for financial instruments. Based on this concept, we believe that the FVOCI category need not be treated differently with respect to fair value option, because both the FVOCI category and the amortised cost category would be subject to the assessments of the contractual cash flow characteristics and the business model.

41. In connection with such equal treatment of the amortised cost and the FVOCI categories, we comment on the relationship between the FVOCI category and the general hedge accounting requirements. The FVOCI category for debt instruments is intended to provide in profit or loss the same information as the amortised cost category. It appears that, under the forthcoming chapter of IFRS 9 on general hedge accounting, the eligible hedged items would be mainly financial assets measured at amortised cost. However, we believe that it would be consistent to also allow financial instruments measured at FVOCI to be eligible hedged items. In addition, the standard should specify how to account for fair value hedges for such debt instruments.

42. Therefore, we hope that the completed version of IFRS 9 would include amendments to allow debt instruments measured at FVOCI to be eligible hedged items and specify the related accounting treatments.

Question 7

Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

43. We agree with the ED's proposal. As noted in paragraphs BC93 and BC94 of the Basis for Conclusions on the ED, it is appropriate to permit only the completed version of IFRS 9 for early application after the completed version is issued, considering the potential decrease in comparability resulting from multiple versions of standards for financial instruments, including IAS 39 *Financial Instruments: Recognition and Measurement*, and the background for the phased approach taken in the project to replace IAS 39.

44. The proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is considered to be appropriate for entities already applying IFRS, assuming that the completed version will be issued around the mid-2013 and the mandatory effective date is January 1, 2015[9]. However, for the first-time adopter of IFRSs, we have a different view, which is provided in our comments on Question 9 in details.

45. We suppose that the ED intends to permit an entity to apply either the completed version of IFRS 9 or previous versions of IFRS 9 for early application during the six-month period subsequent to the issuance of the completed version. However, the description in paragraph 7.1.1A of the ED could be confusing because it may be possible to interpret that the proposed limited amendments to IFRS 9 become effective for early application six months after the completed version of IFRS 9 is issued. Therefore, we suggest stating in the Standard that, for example, "An entity is permitted to early apply this IFRS[10], IFRS 9 (issued in 2009), IFRS 9 (issued in 2010) or IFRS 9 incorporating [draft] Chapter 6 Hedge Accounting for six months after *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) issued on [date to be inserted after exposure]".

Question 8

Do you agree that entities should be permitted to choose to early apply only the 'own credit' provisions

9 This is an assumption set out in the IASB staff paper 6C used at the September 2012 IASB board meeting.

10 "This IFRS" refers to the completed version of IFRS including requirements for classification and measurement (including limited amendments) , impairment and general hedge accounting.

in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

46. We agree that the own credit provisions to recognise the effects of changes in an entity's own credit risk in OCI are appropriate (except for non-recycling treatment), because recognising such effects in profit or loss would not provide useful information unless the financial liability is held for trading.

47. Requests by constituents are understandable, considering the still volatile markets and the increased concerns about the usefulness of reporting gains when an entity is experiencing deterioration in its own credit quality. However, we have the following concern about permitting early application only for the own credit provisions.

48. As noted in paragraph BC103 of the Basis for Conclusions on the ED, if an entity were to early apply only those provisions, only the own credit would be treated based on IFRS 9 while all other financial instruments would continue to be measured based on IAS 39. This would decrease comparability between entities applying IAS 39 which elect early application of the own credit provisions and entities applying IAS 39 without electing it. This could also undermine the benefit of ensuring comparability by the ED's proposal asked in Question 7, which prohibits newly applying previous versions of IFRS 9 six months after the completed version of IFRS 9 is issued.

49. Therefore, if the IASB intends to finalise this proposal as proposed in the ED, we hope this issue to be carefully redeliberated, also noting the risk of confusion to users of financial statements and unintended consequences resulting from such partial early application.

Question 9

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

50. Paragraph BC113 of the Basis for Conclusions on the ED states that the IASB noted that the transition provisions to IFRS 9 for entities that apply IFRS for the first time should generally be the same as for entities already applying IFRS, however, the IASB acknowledged that there are unique considerations for first-time adopters. In our view, if the treatment in Question 7 to entities already applying IFRS were to also apply to first-time adopters, a question of which version of IFRS 9 is available could arise in some circumstances.

51. We acknowledge that the IASB proposed the clarification that "each IFRS effective at the end of an entity's first IFRS reporting period" in paragraph 7 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* means the currently mandatory IFRS or the new IFRS which is not

yet mandatory, if that IFRS permits early application, at the end of an entity's first IFRS reporting period in the Exposure Draft *Annual Improvements to IFRSs 2011-2013 Cycle* (published in November 2012).

52. However, due to the interaction of the existence of multiple versions of IFRS 9 currently applicable before the mandatory effective date and the ED's proposal to prohibit their partial early application, a complex situation may arise that the versions of IFRS 9 available for first-time adopters would significantly differ depending on the timing of the transition to IFRSs. As a result, there may arise a question of which version of IFRS 9 is available for early application in certain reporting period.

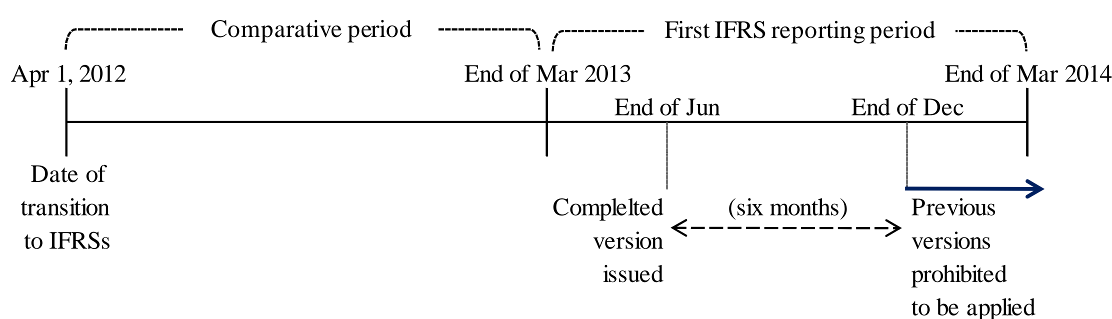
53. For a first-time adopter, there may be two different interpretations about whether previous versions of IFRS 9 are effective at the end of an entity's first IFRS reporting period, if the date that is six months after the completed version of IFRS 9 is issued (when the prohibition on newly applying previous versions of IFRS 9 becomes effective) falls during its first IFRS reporting period.

    (a) Previous versions are not effective because they are prohibited to be applied at the end of an entity's first IFRS reporting period (that is, previous versions are not applicable.).

    (b) Previous versions are effective until the end of an entity's first IFRS reporting period because that period has already started (that is, previous versions are applicable.).

    The following illustration shows the case of a first-time adopter of IFRSs whose date of transition to IFRSs is April 1, 2012.

    [Case of a first-time adopter whose date of transition to IFRSs is April 1, 2012][11]



54. If the IASB were to consider applying the treatment in Question 7 equally to first-time adopters, clarification should be made about which of the interpretation (a) or (b) is appropriate, in order to avoid constituents' confusion.

[11] The timing when the completed version of IFRS 9 is issued is set out as an example in the IASB staff paper 6C used at the September 2012 IASB board meeting.

55. In the case of adopting the interpretation (a), requiring first-time adopters to apply the completed version of IFRS 9 to the comparative period that has already started would be unduly burdensome for first-time adopters because they would not have sufficient lead time to prepare for the completed version[12]. Therefore, in our view, if the first day of the first IFRS reporting period is before the date on which the prohibition on newly applying previous versions of IFRS 9 starts (that is, the date that is six months after the completed version is issued), the first-time adopters should be allowed early application of the previous versions by the interpretation (b).

56. If the IASB would not develop the treatment suggested in the preceding paragraph, we suggest an alternative under which an entity is not required to restate the comparative period and is permitted to use the previous GAAP. Waiving the requirement to restate comparatives in such a manner was once permitted for entities which initially adopt IFRSs for reporting periods beginning before January 1, 2012 and apply IFRS 9 early, in order to strike a balance between the benefits of the full retrospective application and the practicability of adopting the new classification model within a short time frame.

57. Given that the mandatory effective date of IFRS 9 is January 1, 2015, a first-time adopter which is required to apply the completed version of IFRS 9 (that is, previous versions of IFRS 9 are not available) should be permitted to apply the relief of the restatement similar to the previous treatment noted above. This is because the situation would be similar to that addressed by the previous treatment in that the first-time adopters would not have sufficient lead time to prepare the completed version.

Additional issue: Bifurcation of financial assets

58. Although the ED does not set out a specific question about bifurcation of financial assets, we provide comment on this issue as below, because this issue was listed as one of the key areas of the deliberations on the limited amendments to IFRS 9.

59. We believe that hybrid financial assets as well as hybrid financial liabilities should be bifurcated under certain conditions, although we acknowledge that there is an argument that eliminating the bifurcation requirements simplifies the accounting standards for financial instruments.

[12] As illustrated in paragraph 53 of this comment letter, in Japan several entities are preparing for the first-time adoption of IFRSs from the fiscal year ending March 31, 2014 (the end of the fiscal year is often March 31 for many Japanese entities). If those entities, which need to prepare the opening IFRS statement of financial position as of April 1, 2012, have already finished preparing that statement at present, they should apply one of previous versions of IFRS 9. We have received feedback from constituents that such entities would be imposed undue burdens if they were prohibited to newly apply previous versions during the first IFRS reporting period and were required to apply the completed version to the opening IFRS statement of financial position and the comparative period.

60. Bifurcation would result in faithful representation of the economic that an item is composed of elements with different risk characteristics. Separation of one contract into multiple elements is adopted in the IASB's other projects[13]. Additionally, differences in accounting treatments between hybrid financial assets and hybrid financial liabilities could undermine the understandability of accounting standards and thus that of financial statements.

61. Furthermore, because some financial institutions routinely originate hybrid instruments by combining derivatives, consistent treatment of a derivative, regardless of whether it is a stand-alone instrument or is embedded in other instruments, would discourage structuring opportunities and enhance comparability in the accounting for derivatives. In addition, because such financial institutions control the market risk of a portfolio of derivatives including embedded ones using derivatives traded in the market, measuring both derivatives at FVPL would eliminate the necessity to rely on complicated hedge accounting to prevent an accounting mismatch.

62. We believe that the Principal & Interest[14] (P&I) methodology is an approach worth considering for both of hybrid financial assets and hybrid financial liabilities. The P&I methodology bifurcates a hybrid instrument into principal and interest components (identified as a host contract component) and others (identified as embedded components) in accordance with the contractual cash flow characteristics of the instrument. The P&I methodology is more principles-based, and it would reduce practical complexity because it results in a more consistent treatment with the classification model of financial assets.

63. There may be a concern that the P&I methodology would provide excessive flexibility in identifying a host contract component and other components. In order to mitigate such a concern, we believe the P&I methodology should set some additional criteria, including that a host contract component and embedded components should be separately managed, that an entity should regularly trade the stand-alone derivatives similar to the bifurcated embedded features in question and that those derivative instruments and embedded features should be managed in aggregation.

64. Imposing such disciplines would enable the reality of an entity's consistent internal management of instruments on the aggregated (portfolio) basis to be reflected in the accounting treatment and also ensure that bifurcation is not based on the entity's intent for an individual instrument.

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[13] For example, identifying separate performance obligations in the Revenue Recognition project, unbundling investment components in the Insurance Contracts project, and presenting separately liability components and equity components in the Financial Instruments with Characteristics of Equity project.

[14] The Principal & Interest methodology was considered in the IASB/FASB staff paper 6D/140B used at the April 2012 joint board meeting at which the Boards discussed bifurcation requirements.

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

Yours sincerely,

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