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Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
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Dear Sir/Madam,

Comments on the Proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*

We appreciate the efforts of the Financial Accounting Standards Board (FASB) in the Accounting for Financial Instruments project in the past years and welcome the opportunity to comment on the proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities* (hereinafter referred to as the "ED"). The following views are those of the Financial Instruments Technical Committee established under the Accounting Standards Board of Japan.

General Comments

1. We appreciate that the FASB and the International Accounting Standards Board (IASB) (hereinafter collectively the "Boards") have worked together to reduce major differences in their respective classification and measurement models for financial instruments. We also welcome that, as a result of joint deliberations, the Boards have made significant progress in achieving convergence in major areas of classification and measurement requirements. This is consistent with the Boards' objective of the Accounting for Financial Instruments project to increase international comparability in the accounting for financial instruments. We encourage the Boards to continue their joint efforts.

2. We support introducing the approach to classify financial assets based on the contractual cash flow characteristics and the business model in which those assets are managed. The ED proposes identifying financial assets that are appropriate to apply the effective interest method and

determining the classification of such assets based on how the cash flows are collected, which is likely to provide information that is useful in assessing the amounts, timing and uncertainty of the entity's future cash flows. However, with regard to the assessment of the contractual cash flow characteristics, we believe that there are some issues that should be considered further.

3. The ED proposes an unconditional fair value option for financial assets which would otherwise be measured at FV-OCI based on the contractual cash flow characteristics criterion and the business model criterion. However, we believe that the fair value option, if ever permitted, should be restricted with additional criteria because we believe the fair value option is an exception to the classification and measurement model.

4. We believe that, if certain criteria are met, hybrid financial assets should be bifurcated, just as hybrid financial liabilities are bifurcated. Bifurcation would result in faithful representation of the economic substance of an instrument if such instrument is composed of components 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. Additionally, we believe that the bifurcation of hybrid financial assets would help reduce accounting mismatches.

5. Finally, we would like to comment on the classification of investments in equity instruments. In Japan, there are cases where entities invest in equity instruments with the main purpose of establishing and maintaining relationships with the investee and not of seeking capital gains. Entities with such investments have limited discretion to liquidate those investments in order to conduct their ongoing businesses. We do not believe that it is appropriate to recognize the remeasurement gains and losses in net income for such investments because the changes in the value of those investments have little or no relevance in assessing the results of such investments.

6. We acknowledge that in the U.S. markets there are relatively few investments with the features noted in the previous paragraph and, accordingly, concerns with the accounting treatment for such investments may not be significant. However, a number of Japanese entities apply U.S. generally accepted accounting principles and have investments with the features noted in the previous paragraph. Our understanding is that such investments would be measured at FV-NI under the ED's proposal; however, this treatment may not represent the economic substance of these investments and the effects of this accounting treatment are likely to be significant.

7. Additionally, we would like to note that IFRS 9 *Financial Instruments* allows entities to measure investments in equity instruments which are not held for trading at FV-OCI[1]. Accordingly, we encourage the FASB to continue to consider the accounting for investments in equity instruments

[1] IFRS 9 prohibits the recycling of gains and losses into profit or loss when such investments are derecognized. However, we believe that those gains and losses should be recycled.

from the viewpoint of promoting international comparability of accounting standards.

Comments on specific questions

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

Question 4: Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?

Question 6: Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?

Question 7: Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

Question 8: Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?

8. We believe that the notion of the contractual cash flow characteristics is generally appropriate because it states that the objective of the effective interest method for financial instruments measured at amortized cost is to appropriately allocate interest revenue or expense to the relevant periods and that, if interest does not represent the consideration for the time value of money and for the credit risk associated with the issuer of the instrument and with the instrument itself, it is inappropriate to apply the effective interest method. Accordingly, we agree with the FASB's proposal to introduce the notion of the contractual cash flow characteristics. We believe that the ED appropriately conveys the principle associated with the assessment of the contractual cash flow characteristics.

9. We also agree with the ED's proposal which clarifies that, even if financial instruments traded in a particular market included some market norms (such as interest rate reset features and leverages) which may be inconsistent with the economic concept of the time value of money, those instruments might meet the contractual cash flow characteristics criterion. This would lead to the appropriate classification of financial assets and thus provide useful financial information.

10. However, we suggest some clarifications and reconsiderations as follows:

(Difference between "more than insignificant" and "material")

11. Our understanding is that the ED deliberately uses the term "more than insignificant" instead of simply relying on the general notion of materiality in assessing the modified economic relationship. Moreover, our understanding is that, during the Boards' deliberations, it was implied that a modified economic relationship is assessed on a more generous level than the notion of materiality. However, the ED does not refer to this implication. We therefore suggest that such implication be clearly described in the implementation guidance so as to assist the application of this notion in practice.

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

12. Based on the ED, the assessment of the contractual cash flow characteristics 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 criterion.

    (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 criterion.

        (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 criterion.

13. The ED does not explain the underlying concept of what a modified economic relationship is, although it refers to the existence of interest rate reset features or leverages as examples of modified economic relationships. In interpreting process (b-2) in the previous paragraph, the modification of an economic relationship between the three components can mean that cash flows do not represent the time value of money or the credit risk. Accordingly, we find it difficult to conceptually distinguish "modified" in process (b) from "unrelated to the three components" in process (a).

14. For the reason noted above, separating the process of assessing the contractual cash flow characteristics into (a) and (b) above may be confusing and it might be viewed as being inconsistent. In addition, it is unclear as to how to assess the contractual cash flow 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]). Accordingly, we encourage the FASB to consider an approach that alleviates these concerns.

15. For example, one possible alternative[3] may be to simplify the process by combining processes (a) and (b) into a single process in order to assess whether the contractual cash flows include payments unrelated to the three components (that is, the combined process would include the assessment of the interest rate reset features and leverages which the ED intends to capture under the modified economic relationship). In this case, an entity would determine whether the contractual cash flows include payments unrelated to the 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)

16. The ED proposes requiring 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 the assessment methodology.

17. We believe that the implementation guidance should include illustrations of specific assessment methodologies, thereby avoiding confusion in implementation. Although the specific methodology may differ depending on the characteristics of the instrument, possible methods may include a comparison with benchmark cash flows separately for each reset period of interest rates and a comparison with total benchmark cash flows throughout the entire contractual life of the financial asset.

(The meaning of credit risk)

18. The ED does not define credit risk. Furthermore, the Master Glossary in the Accounting Standards Codification defines credit risk for the purpose of a hedged item under hedge accounting. Accordingly, the meaning of credit risk in the context of the assessment of contractual cash flow characteristics is unclear.

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

[3] Our understanding is that one concern under the combined assessment process is that, if a component other than the three components is assessed to be insignificant, the financial asset including that component would be eligible for measurement categories other than FV-NI.

[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.

19. On the other hand, in IFRS 7 *Financial Instruments: Disclosures*, 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." Because the assessment of contractual cash flow characteristics is generally aligned between the FASB and the IASB, we think it is relevant to comment on the meaning of credit risk in IFRSs.

20. We would like to confirm that credit risk potentially includes the 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 the price fluctuation risk of collateralised assets.

21. Paragraph B4.1.16 of IFRS 9 states 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 criterion. This statement may imply that the risk of a loan attributable to the project risk or the price fluctuation risk of collateralised assets is not credit risk[6].

22. However, we believe that the project risk or the price fluctuation risk of collateralised assets represent the debtor's credit risk, if the debtor repays the loan using cash flows from its projects and the interest rate reflects higher risk owing to the non-recourse condition. Accordingly, we would like to confirm that such project risk or price fluctuation risk of collateralised assets included in a financial asset should be considered to be part of credit risk in assessing the contractual cash flow characteristics.

Question 10: Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?

Question 11: Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among 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 proposed guidance provided to describe those business models? If not, why?

23. We support the proposed approach to classify financial assets into three categories (amortized cost, FV-OCI and FV-NI) based on the business model in which those are managed, provided that those

[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.

assets meet the contractual cash flow characteristics criterion. The ED proposes to determine the classification of the financial assets depending on whether cash flows are collected through the collection of their contractual cash flows, through the sale of the instruments, or both. We believe such classification would provide information that is useful in assessing the amounts, timing and uncertainty of the entity's future cash flows. Accordingly, we believe that the proposed amendments appropriately convey the principles associated with the business model assessment.

(Objective evidence relevant to assessing a business model)

24. Paragraph 825-10-55-28 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 management of the business is compensated. However, descriptions in the proposed implementation guidance and the illustrations in the ED do not clearly state which factors provide evidence for which business model. Although it may be difficult to provide a definitive distinction in the standard, an illustration of typical characteristics in a systematic manner as shown in the table below may highlight the differences between the business models and assist in making the judgment.

	FV-NI	FV-OCI	Amortized 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, respond to changes in tax or regulatory requirements
Frequency of sales	Frequent	Depending on the situation (such as an entity's ALM position)	Infrequent in general
Volume of sales	Significant	Depending on the situation (such as an	Insignificant in general

		entity's ALM position)	
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 management is 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)

(Examples of reclassification)

25. The proposed implementation guidance sets out only extreme examples for reclassification of financial assets, such as business combinations and discontinuing operations[7]. Because it also sets out several examples of objective evidence for the determination of the business model, causes of changes in the business models may include how businesses are managed, how performance of the businesses are reported to key management personnel and how management of the business are compensated. Accordingly, adding examples of changes in business models due to changes in how businesses are managed or other changes (that result in reclassification) would facilitate the understanding of constituents. Notwithstanding these suggestions, we believe that the concept in the ED that a change in business model resulting in reclassification is expected to be very infrequent should be retained.

Question 15: The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, all of the following:

a. A group of financial assets and financial liabilities if the entity both:

[7] Our understanding is that the proposed implementation guidance (paragraph 825-10-55-86) referred to the examples described in paragraph B4.4.1 of IFRS 9.

1. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis
2. Provides information on that basis to the reporting entity's management.

b. Hybrid financial liabilities that meet certain prescribed criteria.

c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).

Do these options provide decision-useful information? If not, why?

26. The fair value option is an exception to the classification and measurement model because it is fundamentally inconsistent with the ED's notion of classifying and measuring financial assets based on the contractual cash flow characteristics of those assets and the business model in which those assets are managed. Accordingly, the fair value option should not be permitted unconditionally. If ever permitted, it should be restricted to cases where additional criteria are met. From this viewpoint, we believe that paragraph 825-30-15-4, which permits the unconditional fair value option for financial assets measured at FV-OCI, should be deleted.

Question 18: The proposed amendments would require financial assets measured at amortized cost that are subsequently identified for sale to continue to be classified and measured at amortized cost less impairment and would prohibit recognition of the gain, until the sale is complete. Do you agree with the proposed classification and measurement requirements? If not, why?

27. The ED proposes a principle that the classification of financial assets should be determined based on the business model not at the individual instrument level but at a higher level, such as at a portfolio level. However, the treatment proposed in Question 18 would require an entity to differently account for individual financial assets (or a pool of assets) which the entity subsequently decides to sell and, accordingly, could result in inconsistency within the classification and measurement model. We therefore believe that this treatment should be deleted.

28. Even if this treatment were not included in the final standard, according to paragraph 825-10-55-31, the sales of financial assets classified as amortized cost are considered to be primarily due to the credit risk management and, accordingly, timely recognition of impairment losses (if any) would avoid deferring the recognition of losses. Accordingly, we believe that it is unnecessary to prescribe an exception to the general impairment loss requirements which require recognition in net income of impairment losses (if any), measured as the difference between the asset's amortized

cost (less impairment, if any) and its fair value. Furthermore, if an entity were to follow this proposal, we believe the FASB needs to additionally prescribe the treatment for financial assets that are once identified as being held for sale but subsequently identified as not being held for sale. Although such situation may be rare, prescribing additional treatment would increase complexity.

29. Notwithstanding the discussion above, in regards to financial assets which are to be sold in the near future, we believe that the FASB could require disclosures regarding the amortized cost and fair value of such at the reporting date in order to assist financial statement users in understanding information that is relevant to the gains and losses that would be recognized when the financial assets are sold.

Question 21: Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?

30. We understand that eliminating the bifurcation requirements for financial assets may simplify the accounting for financial instruments. However, we believe that, if certain criteria are met, hybrid financial assets should be bifurcated, just as hybrid financial liabilities are bifurcated.

31. Bifurcation would result in faithful representation of the economic substance of an instrument that is composed of components with different risk characteristics. We note that the separation of a single contract into multiple components is adopted in the FASB's other projects[8]. Moreover, differential accounting treatment between hybrid financial assets and hybrid financial liabilities could undermine the understandability of both the accounting standards and the financial statements.

32. Furthermore, because some financial institutions routinely originate hybrid instruments by combining derivatives, consistent treatment of derivatives, regardless of whether they are stand-alone instruments or embedded in other instruments, would discourage structuring opportunities and enhance the comparability in the accounting for derivatives. In addition, because such financial institutions control the market risk of a portfolio of derivatives (including embedded derivatives) using derivatives traded in the market, measuring both derivatives at FV-NI

[8] 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.

would eliminate the need to rely on complicated hedge accounting to prevent accounting mismatches.

33. We believe that the Principal & Interest[9] (P&I) methodology is an approach worth considering for both hybrid financial assets and hybrid financial liabilities. The P&I methodology would bifurcate a hybrid instrument into principal and interest components (identified as the host contract component) and other components (identified as embedded components) in accordance with the contractual cash flow characteristics of the instrument. The P&I methodology is more principles-based, and would reduce practical complexity because it results in a treatment that is more consistent with the classification model for financial assets.

34. Some may be concerned that the P&I methodology would provide excessive flexibility in identifying the host contract component and embedded components. In order to mitigate such concern, we believe that the P&I methodology in this context should include additional criteria, for example, that a host contract component and the embedded components should be separately managed, that an entity should regularly trade the stand-alone derivatives similar to the bifurcated embedded components and that those derivative instruments and embedded components should be managed in aggregation.

35. Imposing such discipline would enable an entity to reflect in its accounting the economic substance of the internal management consistently provided to the instruments in an aggregated (portfolio) basis and would also ensure that bifurcation is not based on the entity's intent regarding individual instruments.

Question 22: The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?

(Reclassification date)

36. The FASB proposes that the reclassification date is the last day of the reporting period in which an entity's business model changes, whereas 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. We support neither but suggest that the reclassification date should be the date on which the change in business model takes place.

37. One of the reasons for our suggestion is that, if an entity is required to reclassify financial assets at

[9] The Principal & Interest methodology was considered in the IASB/FASB staff paper 6D/140B used at the April 17, 2012 joint board meeting at which the Boards discussed bifurcation requirements.

a timing that is different from that of the change in the business model, as required by the FASB or the IASB, an entity would need to continue, until the reclassification date, to use the accounting classification that no longer faithfully represents the business model in which those assets are managed. We believe this may provide users with misleading information. Additionally, it is likely that the timing the change in the business model is reflected in the financial statements would differ depending on the frequency in interim reporting (for example, quarterly reporting).

38. Our understanding is that the Boards are concerned with the possible arbitrary choice of the date of the change in the business model. We believe this concern relates to how restrictive the change in the business model should be. Under both the FASB's proposal and the current requirements in IFRS 9, a change in the business model is expected to be very infrequent. The change in the business model 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 regarding the arbitrary choice of the dates could be addressed by incorporating a mechanism, in addition to the guidance and disclosures noted above, to objectively determine the timing of the change in the business model, which we explain in the following paragraphs.

(Timing of the change in the business model)

39. As noted in the preceding paragraph, a change in the business model is expected to be very infrequent. However, there still remain ambiguities about when such change in the business model takes place. The following are alternatives for the timing of the change in the business model:

    (a) 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) When a new organization or system under the new business model actually starts to operate according to the decision described in (a) above.

    (c) When a new transaction is actually initiated under the new business model.

40. Alternative (a) may be inappropriate as the timing of the change in the business model because the accounting treatment might not reflect the economic substance that the financial asset is still managed within the previous business model, depending on the timing of the decision-making.

41. On the other hand, Alternative (c) as the timing of the change in business model also may be inappropriate, because once a new organization 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 has been initiated.

42. Consequently, we believe that Alternative (b) would usually be the appropriate timing of the change in the business model. However, the timing should be determined by taking into account all relevant facts and circumstances and, depending on the facts and circumstances, there may be cases where the timing other than that suggested by Alternative (b) is considered reasonable. We believe that, at a minimum, an entity should clearly state the timing of the change in the business model in its documents that record the entity's decision-making.

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

Yours sincerely,

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