Accounting Standards Board of Japan (ASBJ)

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Technical Director
File Reference No. 2012-260
Financial Accounting Standards Board
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Dear Sir/Madam,

Comments on Proposed Accounting Standards Update "Financial Instruments – Credit Losses (Subtopic 825-15)"

We respect the Financial Accounting Standards Board (FASB)'s effort on the financial instruments accounting project, and appreciate the opportunity to comment on the proposed Accounting Standards Update *"Financial Instruments – Credit Losses (Subtopic 825-15)"* (hereafter, "the ED"). The following comments have been prepared by the Financial Instruments Technical Committee, established within the Accounting Standards Board of Japan (ASBJ).

Overall Comments

1. We support the efforts made by the FASB and the International Accounting Standards Board (IASB) (hereafter, "the Boards"), to review accounting standards relating to credit losses on financial assets against the criticism that loan loss recognition lagged during the global financial crisis. Also, we continue to believe that it is important for the Boards to develop a common impairment model, despite the Boards having issued different proposals.

2. In our view, the proposed approach in the ED has advantages in the understandability of both the standard itself and the resulting financial information as it proposes a single measurement objective. In addition, this approach is consistent with the credit risk management practice of entities, because it refers to the absolute level of borrowers' credit risk at each reporting date rather than requiring tracking of credit risks from the initial recognition of financial assets. Further, this approach may be helpful for financial statement users who are interested in analyzing the solvency of reporting entities, as it requires the recognition of all expected credit losses at each

reporting date.

3. However, when developing an improved impairment model, we believe the critical points to consider are to properly portray the relationship between interest income (which includes consideration for bearing credit risks) and credit costs in the statement of comprehensive income, while ensuring that necessary credit losses that can be reasonably estimated are recognized on a timely basis. In our view, properly reflecting that relationship in the statement of comprehensive income would be critical to financial statement users, because such information would be helpful for them to analyze the profitability of an entity's credit risk taking operations, leading to provide relevant information for financial statement users in predicting future net cash inflows into the entity. Looked at from this angle, the impairment model proposed in the ED is not fully conducive to fulfilling these points; therefore, we believe that further improvement is required.

4. Speaking about the practice, an impairment model for credit losses would have a significant impact on financial institutions (especially, banks), as they conduct large-scale credit risk taking businesses. As part of credit risk management operations, they maintain information that can be relevant for the purpose of recognition and measurement of expected credit losses. Hence, when considering a possible impairment model, it would be important to consider whether an entity can utilize such information. By doing so, financial statement preparers can achieve faithful representation, while striking the appropriate cost-benefit balance. In regard to this point, we note that the objective of credit risk management (that is, to maximize recovery of contractual cash flows from borrowers) are generally the same between financial and non-financial institutions, while the degree of precision may differ significantly. Therefore, in considering an optimal impairment model, thinking first about the application of the model to financial institutions would also be effective for non-financial institutions.

5. Taking into account the above mentioned considerations, we have explored a possible alternative impairment model that would meet these effects. In other words, we have explored the alternative model that (i) encompasses characteristics necessary to provide relevant information to financial statement users in predicting future net cash inflows to the entity (as explained in paragraph 3), (ii) enables faithful representation about the economic reality by financial statement preparers while striking the appropriate cost-benefit balance, and (iii) may be acceptable to the Boards. Based on our deliberations, we recommend the Boards consider an alternative impairment

model which includes the following characteristics (For further details, please refer to paragraphs 18 to 48.)

(1) Classify financial assets into two categories, based on the credit status of borrowers as at each reporting date.

(2) Classify financial assets of which contractual cash flows have been recovered and are expected to be recovered in accordance with the manner originally anticipated as "category-1," and classify the rest of financial assets as "category-2." Considering that category-2 financial assets are the ones of which contractual cash flows have not been recovered as originally anticipated, these financial assets would be monitored and managed on an instrument-by-instrument basis, for example by securing collateralized assets and entering into significant modifications to the contractual terms, so as to maximize recovery of contractual cash flows.

(3) For financial assets classified as category-1, recognize the expected credit losses for financial instruments at an amount equal to the one-year expected credit losses.

(4) For financial assets classified as category-2, recognize the expected credit losses for financial instruments at an amount equal to the lifetime expected credit losses. The expected credit loss of a financial asset shall be calculated at an amount equal to the present value of expected cash short falls over the remaining periods.

6. Our comments on specific questions of the ED are detailed in the following paragraphs. In preparing this comment letter, we focused on the questions that are most relevant to the development of a common impairment model by the Boards, but we have provided comments on other questions as considered necessary.

Comments on Questions in the ED

Scope

Question 1: Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?

7. We are of the view that the scope of financial assets included in the ED is generally appropriate. However, we are unclear about whether the FASB intends that all or some of financial guarantee contracts be included within the scope of the proposed

requirements of the ED.

8. We presume that this scoping question will be deliberated as part of the *Insurance Contracts* project. However, in order to avoid any confusion in practice, we encourage the FASB to clarify the effect when finalizing the proposed standard.

Recognition and Measurement

Question 2: The proposed amendments would remove the initial recognition threshold that currently exists in U.S. GAAP and, instead, view credit losses as an issue of "measurement" as opposed to an issue of "recognition" because the credit losses relate to cash flows that are already recognized on the balance sheet. Do you believe that removing the initial recognition threshold that currently exists in U.S. GAAP so that credit losses are recognized earlier provides more decision-useful information?

Question 3: As a result of the proposed amendments, the net amortized cost on the balance sheet (that is, net of the allowance for expected credit losses) would reflect the present value of future cash flows expected to be collected, discounted at the effective interest rate. Do you agree that the net amortized cost (which reflects the present value of cash flows expected to be collected) results in more decision-useful information than currently exists under U.S. GAAP?

Question 4: The Board has twice considered credit loss models that would permit an entity not to recognize certain expected credit losses. In the January 2011 Supplementary Document, the Board considered a model that would permit an entity not to recognize some credit losses expected to occur beyond the foreseeable future. In the recent discussions on the three-bucket impairment model, the Board considered a model that would permit an entity only to recognize lifetime credit losses for loss events expected to occur within a 12-month horizon. Instead, the proposed amendments would require that at each reporting date an entity recognize an allowance for *all* expected credit losses. Do you believe that recognizing *all* expected credit losses provides more decision-useful information than recognizing only *some* of the expected credit losses? If not, how would you determine which expected credit losses should not be recognized (for example, 12 months or similar foreseeable future horizon, initial recognition threshold, and so forth)?

General Views on the Proposed Impairment Model Requiring the Recognition of All Expected Credit Losses at Each Reporting Date

9. The ED proposes an approach that recognizes all contractual cash flows not expected to be collected as expected credit losses at each reporting date, by eliminating the threshold which currently exists in U.S. GAAP (that is, to recognize impairment losses when "it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.")

10. Eliminating the threshold and considering reasonable and supportable forecasts to estimate expected losses would lead to earlier recognition of credit losses compared with the existing U.S. GAAP, and would help address criticisms that credit loss recognition came "too little, too late" at time of the global financial crisis. However, we do not support the proposed approach, because we are not convinced that recognizing all expected credit losses would provide more decision-useful information than recognizing only some of the expected losses, for the reasons stated in paragraphs 11 to 14 of this comment letter.

11. The FASB's proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities* issued in February 2013 proposed that a financial asset measured at amortized cost or FV-OCI is generally held within the following business models:

    (1) A financial asset measured at amortized cost – Held and managed within the business model of which objective is to collect contractual cash flows of the asset.

    (2) A financial asset measured at FV-OCI – Held and managed within the business model which has both of the following objectives:

        (i) Holding the asset to collect its contractual cash flows; and

        (ii) Selling the asset.

12. For financial assets held within such business models, it would be important to properly portray the relationship between interest income and the related costs (including credit costs and funding costs) in the statement of comprehensive income, as far as they meet the contractual cash flow characteristics test. In our view, properly reflecting this relationship in the financial statements would provide users with information about the profitability of an entity's business activity that is relevant to predicting future net cash inflows into the entity.

13. There may be a view that the proposed approach, which requires recognition of all expected credit losses at each reporting date, would provide more decision-useful

information especially for financial statement users who are interested in analyzing the solvency of the reporting entity. This is because all expected credit losses over the remaining life of the financial asset would be reflected in the statement of financial position in accordance with the proposed approach. In fact, when the ASBJ staff reached out to users of financial statements, analysts from a credit rating agency expressed general support for the FASB's approach for that reason.

14. However, the proposed approach does not require that future interest income (which includes consideration for bearing credit risks) will be recognized in the financial statements, although all future credit losses are recognized. In our view, this distorts the economic reality both in the statement of comprehensive income and the statement of financial position, and thus does not faithfully represent the performance and financial condition of an entity.

15. For these reasons, we do not believe that the approach proposed in the ED would faithfully represent an entity's credit risk taking; thus would not result in relevant information for financial statement users in predicting future net cash inflows into an entity. When the ASBJ staff reached out to financial statement users, equity analysts expressed disagreement with the approach, because of the concerns about the decision-usefulness of the resulting information, due to the mismatch between credit costs and interest income.

Discount Rates Used for the Estimate of Expected Credit Losses

16. The ED proposes that an estimate of expected credit losses shall reflect the time value of money, and that if an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized in that model shall be the financial asset's effective interest rate.

17. We understand that this method was adopted with a view to earlier recognition of credit losses; however, this method is not consistent with the presumption that the transaction price should be equal to the fair value in an arm's length transaction, as it always gives rise to day-one losses. Moreover, in our view, this approach effectively double counts the expected credit losses in both the numerator and denominator in calculating expected credit losses because consideration for bearing credit risks is reflected in the effective interest rate of the denominator in a discount future cash flow model. Accordingly, we are not convinced that the proposed approach is theoretically sound or sufficiently persuasive.

A Possible Alternative Approach

Why are We Suggesting the Alternative Approach?

18. The Boards' deliberations to date suggest that when developing the impairment model, consideration should not just be given to whether the model is capable of providing relevant information to users, but also if the model enables financial statement preparers to faithfully represent the economic reality without imposing undue cost. In the following paragraphs, we will explain a proposed alternative impairment model that we believe is capable of providing relevant information to users but that can also achieve faithful representation while meeting the appropriate cost-benefit balance.

19. As noted in paragraphs 13 and 15 of this comment letter, views on relevant impairment models would differ depending on interested areas of financial statements users. However, having regard to the FASB Statement of Financial Accounting Concepts No.8 *Conceptual Framework for Financial Reporting* which explains that users of financial statements need information to help them assess the prospects for future net cash inflows to an entity[1], we believe that emphasis should be placed on the following matters in the development of an improved impairment model.

    (1) For the statement of comprehensive income – The relationship between interest income (which includes consideration for bearing credit risks) and credit costs should be properly reflected, while ensuring that necessary expected credit losses that can be reasonably estimated are recognized on a timely basis. As noted in paragraph 12 of this comment letter, we believe that properly portraying this relationship would enhance the decision-usefulness of information about the performance of an entity[2].

    (2) For the statement of financial position – Necessary amount of allowance should be recognized for credit costs (this means that allowance should not be understated nor overstated. Therefore, the notion of "sufficiency" is not the sole determinant for the level of allowance.). In this regards, because the estimate of credit costs is highly uncertain and cannot be determined accurate in all respects, a reasonable range of estimates should be permitted to achieve faithful representation[3].

20. In light of the factors described in the previous paragraph, we are generally of the view that the proposed approach for purchased credit-impaired financial assets in the ED

[1] See paragraph OB3 of Chapter 1: *The Objective of General Purpose Financial Reporting*, the FASB Statement of Financial Accounting Concepts No.8

[2] See paragraph OB16 of Chapter 1: *The Objective of General Purpose Financial Reporting*, the FASB Statement of Financial Accounting Concepts No.8

[3] See paragraph QC15 of Chapter 3: *Qualitative Characteristics of Useful Financial Information*, the FASB Statement of Financial Accounting Concepts No.8

and the impairment approach proposed in the IASB's 2009 Exposure Draft generally would be considered as the theoretically appropriate approach, albeit some shortcomings exist (for example, these approaches presume a too simple and unrealistic credit loss recognition pattern.) These approaches are distinctive in that they require that interest income be recognized on the basis of credit adjusted effective interest rates.

21. However, feedbacks from stakeholders (both domestically and internationally) have suggested that although such an impairment model could be applied to an individual financial instrument, its application to an open portfolio would be extremely difficult. In other words, although these approaches themselves may be capable of providing relevant information, it would be difficult for an entity to faithfully represent the economic reality, if the existing credit risk management and information systems were not changed substantially. This is because based on these approaches, financial institutions holding a large volume of financial assets cannot utilize information maintained for their credit risk management purposes; therefore, they would have to rely on alternative data which may not necessarily be precise. As a consequence, the resulting information would not be sufficiently relevant for financial statement users. There are at least the following reasons:

    (1) *High volume of debt instruments held by financial institutions* – Financial institutions hold a large volume of debt instruments and usually manage them on a portfolio basis rather than on an instrument-by-instrument basis. They often have a strategy to maintain a portfolio's risk profile to the desirable level through purchases and sales of individual instruments. In other words, except for limited major investments, their focus is usually on the risk profile of a portfolio as a whole rather than that of individual instruments.

    (2) *Consistency with credit management practice in financial institutions* – In most cases, after underwriting loans to borrowers, financial institutions are not able to raise an interest rate even if the credit risks of borrowers have significantly deteriorated since inception. Therefore, after underwriting, financial institutions' focus is generally on minimizing credit costs rather than maximizing credit spreads. Financial institutions thus monitor a static level of credit risk of borrowers periodically rather than changes in the credit risk. This means that available information capable of capturing changes in credit risks is very limited under their existing information system.

Our Alternative Approach

22. Having considered the matters stated in paragraphs 18 to 21 of this comment letter, we have deliberated a possible alternative impairment model that would meet the factors in paragraph 19. In other words, we have explored an alternative model that (i) encompasses characteristics necessary to provide relevant information to financial statement users in predicting future net cash inflows to the entity (as explained in paragraph 19), (ii) enables making faithful representation by financial statement preparers while striking appropriate cost-benefit balance, and (iii) may be acceptable to the Boards. Based on our deliberations, we recommend the Boards consider an alternative impairment model which includes the following characteristics:

    (1) Classify financial assets into two categories, based on the credit status of borrowers at each reporting date.

    (2) Classify financial assets of which contractual cash flows have been recovered and are expected to be recovered in accordance with the manner originally anticipated as "category-1," and classify the rest of financial assets as "category-2." Considering that category-2 financial assets are the ones of which contractual cash flows have not been recovered as originally anticipated, these financial assets would be monitored and managed on an instrument-by-instrument basis, for example by securing collateralized assets and entering into significant modifications to the contractual terms, so as to maximize the recovery of contractual cash flows.

    (3) For financial assets classified as category-1, recognize the expected credit losses for financial instruments at an amount equal to the one-year expected credit losses.

    (4) For financial assets classified as category-2, recognize the expected credit losses for financial instruments at an amount equal to the lifetime expected credit losses. The expected credit loss of a financial asset shall be calculated at an amount equal to the present value of expected cash short falls over the remaining periods.

Explanation to Our Alternative Approach

(Classifying Financial Assets into Two Categories)

23. Some may hold the view that classification of debt instruments into multiple categories would be almost impossible, because deterioration in borrowers' credit standings occur gradually. However, in practice, when the recovery of contractual cash flows is not expected from financial assets as originally anticipated, entities

usually segregate them from the rest of the assets in their credit risk management process. In such a case, entities might well manage these financial assets not only on the basis of a probability-of-default (PD) statistic but increased attention are often paid to a loss-given default (LGD) statistic. Said differently, it may be possible to distinguish credit risk management practices into those with particular emphasis on the PD and those with increased attention to LGD.

24. In our view, when establishing a possible impairment model, focusing on this difference in credit risk management processes would contribute to properly portraying interest income and credit costs during reporting periods, while ensuring that necessary expected credit losses that can be reasonably estimated are recognized on a timely basis (see paragraph 19(1) of this comment letter.) This is the primary reason why we are proposing classification of financial assets into two categories.

25. This approach (requiring classification of financial assets into two categories on the basis of entities' credit risk management) is similar to the approach proposed in the Boards' Supplementary Document (SD) *Financial Instruments: Impairment* issued in 2011 which required classification of financial assets into 'good book' and 'bad book.' As part of the feedback process to the SD, stakeholders expressed a particular concern that this approach would be arbitrary, because entities with lax credit risk management practice may have to recognize lesser expected credit losses. In order to address such concern, our proposed approach does not just rely on entities' credit risk managements, although our proposal and the SD's approach would yield similar conclusion in many cases. Specifically, our proposal refers to an expectation as to the recovery of contractual cash flows, in addition to the credit risk management practice.

26. At the same time, we propose that the Boards develop robust application guidance which illustrates situations where credit risk management is expected to be undertaken more on an individual basis. For example, the application guidance should state that financial assets of which contractual terms have been substantially modified be classified as category-2, because they are usually managed on an individual basis. In addition, the application guidance should also state that financial assets that meet the criteria relating to objective evidence of impairment as set out in IAS 39 *Financial Instrument: Recognition and Measurement* be classified as category-2. Following this, purchased or originated credit impaired financial assets will be classified as category-2.

27. Furthermore, using the examples in paragraph B20 of the IASB's Exposure Draft

Financial Instruments: Expected Credit Losses issued in 2013 (hereafter, "the 2013 IASB ED"), the application guidance may also include following examples as indicators in determining if financial assets are classified as category-1 or category-2.

(1) Whether the external credit rating or the credit spread for the borrower has been decreased below a certain level.

(2) Whether the internal credit rating for the borrower has been decreased below a certain level.

(3) Whether the actual or expected financial position and performance of the borrower are adverse as a result of changes in business conditions or the regulatory environment of the borrower.

(4) Whether covenants stated under the loan agreement are breached.

(Calculation of Expected Credit Losses for Financial Assets Classified as Category-1)

28. For financial assets classified as category-1, it is expected that credit risks are usually monitored and managed on a portfolio basis. Accordingly, for these assets, calculating expected credit losses on a portfolio basis is consistent with the entity's credit risk management. As for the measurement objective, we think that one-year expected credit losses after the reporting date should be appropriate for the following reasons.

29. As stated in paragraph 19(1), we believe what is important to properly portray the relationship between interest income and credit costs, while ensuring that necessary credit losses that can be reasonably estimated are recognized on a timely basis. We note that fulfilling the objective is not always easy, because the former point is to ensure matching between income and expense, while the latter point is to address uncertainties of accounting estimates.

30. However, when we have the measurement objective of one-year expected credit losses, the period over which an entity recognizes interest income would coincide with the period for which an entity estimates expected credit losses, due to the fact that an accounting period is usually a one-year period. In addition, some existing provisions require an entity to estimate for a one-year period from the reporting date, in light of estimation uncertainties. For example, when assessing whether the going concern assumption is appropriate, an entity is often required to assess its ability to continue as a going concern in twelve months from the end of the reporting period. Accordingly, a one-year period would be considered as a reasonable time-frame in light of ensuring

a reasonable estimate of expected credit losses. Furthermore, taking into account the financial institutions' credit risk management practices and the historical data obtained in the last 10 years in Japan, our proposal would generally meet the abovementioned points.

31. It is presumed that an entity usually calculates expected credit losses on the basis of a portfolio balance times loss ratios which are developed on the basis of an entity's historical loss experience, because the historical data is highly verifiable and is more likely to achieve faithful representation. However, considering that historical experience does not necessarily reflect future trends, updating for current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date would be necessary.

32. In many cases, loss ratios could be developed by averaging historical loss experience over several past periods, updating as necessary, to calculate one-year expected credit losses. However, if credit losses are not expected to occur ratably throughout the contractual period of the financial assets, the effect on how credit losses would emerge should be taken into account in calculating expected credit losses.

33. In addition, it is not necessary that financial assets in category-1 be aggregated as a single portfolio; rather, they should be appropriately disaggregated according to their nature and risk profiles. In disaggregating financial assets, internal credit risk ratings made by the financial institutions might be used. Applicable loss ratio for each portfolio would differ, if they were developed based on historical experience as adjusted necessary.

34. For financial assets classified as category-1, discounting expected credit losses to arrive at the present value may not be necessary. This is because the effect of discounting would often be insignificant for financial assets in category-1, and that the effect of discounting may not be calculated precisely because expected credit losses are normally calculated on the basis of the portfolio balance times the loss ratio.

(Calculation of Expected Credit Losses for Financial Assets Classified in Category-2)

35. By definition, financial assets classified as category-2 are usually managed on an instrument-by-instrument basis. Accordingly, we may well expect that an entity possesses information necessary to reasonably estimate the expected cash flows of financial assets over their remaining periods.

36. Because of that, we believe that it is appropriate to estimate expected cash flows over

the remaining life of individual financial assets (which is the remaining life of a contractual period, taking into account expected prepayments) and to discount any expected losses using the effective interest rate. In addition, interest income should be recognized for these assets, as the effect on discounting are unwound with the passage of time; hence, those financial assets would not be on a non-accrual status.

37. Separate presentation may be appropriate for credit losses on financial assets classified as category-1 and category-2, because the period of time over which an entity estimates expected credit losses may differ significantly.

(Application to non-financial institutions)

38. As mentioned in paragraph 4, the impairment model for credit losses has a significant impact on financial institutions. Accordingly, when we explored the possible alternative approach, we initially focused on an optimal impairment model for financial institutions. Nevertheless, application to non-financial institutions is equally important, because credit losses also incur in these entities. Though the degree of precision in credit risk management by non-financial institutions may be far different from that of financial institutions, the objectives and general approaches to credit risk management would be consistent between financial institutions and non-financial institutions. When an entity does not expect to collect cash flows from financial assets according to their contractual terms, both financial and non-financial institutions aim to minimize the incurrence of credit losses by trying to maximize cash recovery through securing collaterals or other means. Therefore, we believe that our proposed approach could also be relevant to non-financial institutions.

39. However, some entities possessing a large volume of trade receivables may not perform credit risk management on an individual basis even for those financial assets classified as category-2 due to the cost-benefit balance. In such a case, an entity may not maintain information necessary to make reasonable estimates of expected cash flows on an individual basis. Where that situation applies, we think that the use of practical expedients (such as a provision matrix method) should be permitted.

Benefit of Our Alternative Approach

40. As stated in paragraphs 18 to 21, although it may not be perfect, we believe that our proposed approach would address important points in the development of an expected credit loss model (including, proper matching between interest income and credit costs in the statement of comprehensive income, addressing increased uncertainties in the estimate and appropriately reflecting anticipated future losses in the statement of

financial position) with consideration for the cost-benefit balance. Furthermore, we believe that our proposed approach has the following benefits.

(Response to the Concerns Expressed in Global Financial Crisis)

41. Our proposed approach explicitly requires that an entity recognize a certain amount of expected credit losses for financial assets classified as category-1. In other words, an entity must recognize credit losses for financial assets on which there is no objective evidence of impairment. Accordingly, our model would address concerns cited during the financial crisis over lagging recognition of impairment losses.

(Consistency with the Entity's Credit Risk Management)

42. Our proposed approach is developed based on the credit risk managements that are expected to entities (including those of financial institutions). Therefore, we expect that entities can utilize the existing information maintained for their credit risk management purposes to faithfully represent their expected credit losses, without making significant changes to their information systems. In addition, such information is generally considered highly reliable, because the information is often examined and inspected by financial supervisory authorities. Furthermore, our proposal could avoid the risk of having significant inconsistency between financial information based on accounting standards and financial information prepared for supervisory purposes, because the credit risk management processes of financial institutions are often established to meet supervisory requirements.

43. Moreover, unlike the approach proposed in the 2013 IASB ED, our proposed approach does not require an entity to assess deterioration of credit risks from the inception of financial assets. Accordingly, our approach addresses the criticism to the IASB's approach that the tracking of changes in credit risks is almost impossible. Our approach also addresses the criticism that it is counterintuitive to recognize 12-month expected credit losses for some loans while life-time expected credit losses are required for other loans to the same borrower, when the source of the borrower's cash flow is the same.

44. As stated in paragraphs 38 and 39, we believe that our approach could also be applied to non-financial institutions.

(Response to the Criticism to the Absolute Approach)

45. We are aware that there is a criticism to the approach segregating financial assets into different categories based on the credit standing of borrowers at each reporting date (hereafter, "the absolute approach") has some shortcomings. For example, some

have suggested that subprime loan lenders may have to recognize excessive expected credit losses based on the absolute approach, because that approach may require recognition of life-time expected credit losses at their initial recognition.

46. In this regard, our alternative approach requires that financial assets be classified in category-1 or category-2, based on whether their contractual cash flows have been recovered and are expected to be recovered as originally anticipated (in other words, the classification is made on the basis of how these assets are monitored and managed.)

47. Even in case of subprime lending, lenders usually monitor and manage the credit risk of financial assets at a portfolio level until credit risks of financial assets deteriorate to the point when they do not expect that contractual cash flows will be recovered as anticipated. This means that based on our alternative approach, even for subprime lenders, many loans starts from the category-1 at their initial recognition. Accordingly, we believe that our alternative approach could alleviate the criticism raised for the absolute approach.

(Response to the Concerns against Recognition of Day-One Losses)

48. Under the presumption that an entity originates or purchases financial assets under arm's length conditions, the transaction price of an individual financial asset should be equal to its fair value; therefore, the credit loss should not be recognized at the initial recognition so as to appropriately reflect the economic reality[4]. Although our proposed alternative approach might fall short of resolving the concern entirely, we think that our approach would significantly alleviate the concern, because it requires an entity to recognize expected credit losses on a portfolio basis. By doing so, we may be able to avoid the explicit question as to whether day-one losses should (or should not) be recognized, because a portfolio consists of financial assets with different inception dates and contractual maturities.

Question 5: The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows. Do you believe that expected credit losses based on this information provide decision-useful information?

[4] FASB Accounting Standards Codification paragraph 820-10-30-3

49. The FASB's Statement of Financial Statement Concept No.8 states that information must be relevant and faithfully represent what it purports to represent, so as to ensure that information is useful for decision making by financial statement users[5]. Considering that the expected credit loss model proposed in the ED may apply to loans with long periods remaining to settlement, we believe that the guidance that helps ensure representational faithfulness should be sufficiently robust. Accordingly, we are of the view that further clarification is required as to the notion of "reasonable and supportable forecasts" that the ED requires that an entity consider in estimating expected credit losses.

50. For example, some stakeholders expressed a view that it is practically difficult to reasonably estimate expected credit losses beyond a certain period of time (such as, one-year or two to three years) after a reporting date. The longer the period, the more significant the judgments preparers and auditors would be required to exercise when forecasting future cash flows. The increased significant judgment would impose difficulties for verifying the reasonableness of such judgments. For example, it is not rare in Japan that contractual periods of residential mortgage loans extends as long as 30 or 40 years, and commercial banks keep such loans without entering into off-balance sheet treatment, for example securitization. Accordingly, we recommend that the FASB explicitly permit an entity to 'extrapolate' its estimate of the future cash flows beyond a certain period of time, based on the estimate of future cash flows up to the period that they can be reasonably estimated.

51. In addition, there are many other cases where significant judgment is required for estimating expected credit losses. This includes to what extent country risks should be considered in the assessment of future cash flows from borrowers in foreign companies, and how an entity should take into account the expected outcome of litigation when its borrowers are involved in significant litigation cases. Furthermore, making reasonable forecasts as to changes in macroeconomic environments would be significantly challenging in light of verifiability. Therefore, we recommend that the FASB provide clear guidance about what factors should be considered along with how they can be considered (for example, whether to use the probability-weighted method or most likely outcome method).

Question 6: For purchased credit-impaired financial assets, the proposed amendments

[5] See paragraph QC4 of Chapter 3: *Qualitative Characteristics of Useful Financial Information,* the FASB Statement of Financial Accounting Concept No.8

would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be amortized into and recognized as interest income over the life of the asset. To achieve this result, upon acquisition the initial estimate of expected credit losses would be recognized as an adjustment that increases the cost basis of the asset. Apart from this requirement, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you believe that using the same approach to recognize changes in the credit impairment allowance for purchased credit-impaired assets and non-purchased-credit-impaired assets provides decision-useful information? Do you believe that this is an improvement from the current model used for purchased credit-impaired assets?

52. The ED proposes to define expected credit losses as an estimate of all contractual cash flows not expected to be collected from a recognized financial asset or commitment to extend credit. We believe that recognition of the initial estimate of expected credit losses for purchased credit-impaired financial assets upon their acquisition (that is, to reflect the expected credit losses that have emerged since the inception of such financial assets) would be appropriate in order to ensure consistency with the proposed definition.

53. In addition, we think that the proposal in the ED would be sufficiently practicable, because the quality and quantity of the borrowers' information maintained for purchased credit-impaired financial assets is expected to be superior to that of other assets. Therefore, we agree with the accounting treatment for purchased credit-impaired financial assets proposed in the ED.

Question 7: As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost amount of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. The proposed amendments would require an entity to

disclose the amortized cost basis of assets that apply this practical expedient each period. Do you believe that the practical expedient for some financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income is reasonable? Why or why not?

54. We support the practical expedient proposed in the ED. We understand that the practical expedient was proposed to provide operational relief primarily to bond holders who have limited access to borrowers' information. For such bondholders, it is often difficult to obtain objective information about the borrowers' credit status other than external credit ratings, thus it would be difficult for them to achieve faithful representation. Accordingly, when credit losses are expected to be insignificant, we believe trying to segregate fair value changes attributable to credit risk from those attributable to other risks may not always result in useful information for financial statement users.

55. Furthermore, if this practical expedient were proposed to allow operational relief where credit losses are expected to be insignificant, we recommend that the FASB consider that criteria (b) in paragraph 825-15-25-2 of the ED be the only necessary criterion and that criteria (a) in the same paragraph be used as the potential evidence to support the assertion.

Question 8: The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this approach provides decision-useful information?

56. The ED proposes that an estimate of expected credit losses shall reflect the time value of money. Therefore, in theory, we believe it is necessary to recognize interest income over the passage of time.

57. However, in limited situations, the ED permits an entity to estimate expected credit losses without explicitly discounting the losses; therefore, we may well say that it is not be always necessary to recognize interest income over the passage of time. In addition, in the revenue recognition standards, revenue would not be recognized until when an entity is certain as to of the collectability of consideration. For these reasons,

we do not disagree with the proposal requiring an entity to cease its accrual of interest income when certain conditions are met.

Disclosures

Question 17: Do you believe the disclosure proposals in this proposed Update would provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?

58. We are of the view that the proposed disclosure requirements are generally appropriate as they are relevant for financial statement users to understand the proposed approach for recognition and measurement of expected credit losses in an entity's financial statements. However, we are unclear about the FASB's intention as to the roll-forward information regarding the allowance for credit losses proposed in paragraph 825-15-50-10 of the ED. We understand that this roll-forward information is carried forward to maintain the disclosure requirement in the Accounting Standards Update No.2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses,* which is explained in paragraph BC 49 of the ED. However, the ED does not retain the scope exception set out in the existing requirements (Accounting Standards Codification 310-10-50-11A).

59. We understand that the FASB intends to retain many of the existing disclosure requirements other than areas where changes to recognition and measurement requirements are proposed as a result of the new impairment model set out in the ED. Thus, we are unclear about the reason why the existing scope exception was removed from the ED. In our discussion with stakeholders, financial statement preparers expressed concerns about the proposal, because they are not sure if the benefit would outweigh the cost.

60. Roll-forward information could be relevant for financial statement users to better understand changes in the credit risks of an entity's financial assets. This is because it explains why the allowance for credit losses changed during a reporting period by disclosing the break-down of net changes in the balance during the period (such as, current period provisioning, reversal, and write-offs charged against the allowance). On the other hand, financial statement preparers expressed the view that if an entity were to provide roll-forward information particularly about trade receivables (including the ones of which contractual periods are relatively short), the practical burden would be significant because it would need to trail the information about

allowance for receivables that have no beginning or ending balance at reporting periods. In addition, paragraph 825-15-50-14 of the ED proposes that roll-forward information would not be provided for gross-carrying amounts of receivables that result from revenue transactions.

61. Accordingly, we recommend that the FASB revisit the proposed requirement by considering whether removal of the scope exception is still appropriate in light of the cost-benefit balance; and if the proposed roll-forward information is found to be necessary, we recommend the FASB to consider whether and how the requirement could be simplified.

Implementation Guidance and Illustrations

Question 19: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?

62. The ED proposes estimation of expected credit losses involving higher degrees of uncertainty. Accordingly, if the FASB were to retain the requirements to recognize expected credit losses over the remaining life of financial assets, we recommend that the FASB provide further implementation guidance and illustrative examples, so as to address the questions about how reasonable estimates can be made of expected credit losses (see our response to Question 5.).

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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