

## Financial Accounting Standards Foundation (FASF)

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May 27, 2005

Committee of European Securities Regulators  
11-13 Avenue de Friedland  
75008 Paris  
France

Dear Sirs,

### **Comments on the Draft Technical Advice on Equivalence of Certain Third Country GAAP and Description of Certain Third Countries Mechanisms of Enforcement of Financial Information**

The Accounting Standards Board of Japan (ASBJ) appreciates that the Committee of European Securities Regulators (CESR) gave us an opportunity to comment on the “Draft Technical Advice on Equivalence of Certain Third Country GAAP and Description of Certain Third Countries Mechanisms of Enforcement of Financial Information”(Draft Technical Advice).

We are pleased that the CESR concluded that Japanese GAAP, as a whole, was equivalent to International Financial Reporting Standards (IFRSs), together with US and Canadian GAAP in the Draft Technical Advice. We are also glad that the CESR acknowledged the recent efforts by Japan as we have developed accounting standards that have reached a level of high-quality, internationally recognized accounting standards since the mid 1990s in the light of a globalization of capital markets. In addition, we are grateful that the Draft Technical Advice refers to the fact that the ASBJ agrees to the goal of international convergence toward high-quality accounting standards, and also refers to the joint project for convergence with the IASB.

We hope that, in the assessment of individual accounting standards, the CESR maintains the stance that “third country GAAP can be declared as equivalent to IAS/IFRS when financial statements prepared under such third country GAAP enable investors to take at least similar decision” stated in the “Concept Paper on Equivalence of Certain Third Country GAAP and Description of Certain Third Countries Mechanisms of Enforcement of Financial Information” (Concept Paper) and that the CESR will focus on significant differences when considering remedies.

As stated in our comments on the draft Concept Paper, we believe that the CESR should take into account the rationale present in differences between IAS/IFRS and third country GAAP when considering the need for specific remedies. We believe that the narrative information that draws investors' attention to differences between respective accounting standards is useful, but the quantitative information that merely eliminates the difference of targeted accounting standards may give biased information to investors who evaluate the entity by paying attention to the relationship between numbers. We believe that sophisticated investors do not automatically combine the figures under the different standards but assess by themselves based on the information which explains the difference between standards in an appropriate manner. In many cases where the Draft Technical Advice requires supplementary statements or quantitative indication (Disclosure C), which is substantially equal to reconciliation, investors will be able to make adequate investment decisions if the reporting entities draw investors' attentions by the additional narrative information.

In the following sections, we will refer to the progress of the joint project with the International Accounting Standards Board (IASB), and then will comment on issues for which we request the CESR to reconsider remedies, most of which are supplementary statements.

## **I. Progress of the joint project with the IASB**

The ASBJ agrees that the objective of international convergence to achieve high-quality accounting standards is beneficial to respective capital markets around the world. Based on this view, the ASBJ held an initial meeting on the joint project for convergence with the IASB in Tokyo on March 9 and 10, 2005 and the next meeting will take place in London in this September.

The purpose of the joint project with the IASB is to minimize differences between IFRSs and Japanese accounting standards towards a final goal of convergence of both standards. The boards decided to adopt a phased approach to the comparative reviews of differences in individual standards. Standards under review or intended to be reviewed in the joint projects between the IASB and the US Financial Accounting Standards Board (FASB), standards that are divergent owing to differences in their respective conceptual frameworks or basic philosophies, or standards recently developed by each board will be discussed later. Our respective conceptual frameworks will be discussed as a separate sub-project in the future.

At the discussion during the initial meeting, the boards agreed that following five issues would be deliberated as the topics in the first phase. The boards also agreed to discuss whether more topics

could be added in the first phase.

- i) measurement of inventories (consideration of the mandatory application of the lower of cost or market under Japanese GAAP) (IAS 2)
- ii) unification of accounting policies applied to foreign subsidiaries under Japanese GAAP (IAS 27)
- iii) related party disclosures (IAS 24)
- iv) segment reporting (IAS 14)
- v) investment property (reconsideration of the definition and the choice of the cost model and the fair value model under IAS 40)

Since May 2005, the ASBJ has already begun deliberation of topics in the first phase so that they will be addressed within a year or two. With respect to the measurement of inventories, for which remedies are required in the Draft Technical Advice, the ASBJ decided to establish a Technical Committee and will plan to issue the exposure draft of the accounting standards in early next year. We will also deliberate the unification of accounting policies applied to foreign subsidiaries in order to revise the current guidelines at the Practical Solutions Standing Committee and will issue the exposure draft by the end of this year.

Thus, the ASBJ will deal with the topic in the first phase as quickly as possible, subject to consensus among market participants.

## **II. Issues the ASBJ requests to reconsider remedies**

### **1. Supplementary statements**

The Draft Technical Advice requires supplementary statements for the following items;

- 1) Pooling of interests (IFRS3)
- 2) Scope of consolidation (SPE, Potential voting rights) (IAS27)
- 3) Uniformity of accounting policies (IAS27)

#### **1) Pooling of interests (IFRS3)**

As described in the Draft Technical Advice, there are limited situations where no party obtains control over the other upon business combinations and thus shareholders' interests in entities are not discontinued thereon. In such a case, under Japanese GAAP, the pooling-of-interest method is applied only if a business combination meets strict criteria shown in the attached flowchart and is determined as a combination of equity. In addition, the reason to be judged as a combination of

interests should be disclosed in the note to financial statements.

If the purchase method is applied in this case, an acquirer and acquirees need to be determined, and assets and liabilities of acquirees shall be revaluated. Not only is it questioned in view of disclosure of the substances of business combinations but also difficult to apply from technical aspects.

## **2) Scope of consolidation (SPE, Potential voting rights) (IAS27)**

The proposal of supplementary statements related to the scope of consolidation in the Draft Technical Advice seems to consist of two topics; that is, SPE and potential voting rights, and therefore we would like to explain each separately.

### **A. SPE**

Under Japanese GAAP, the scope of consolidation is determined based on control. When SPEs are established for the objective of the issuance of asset-backed securities, and are properly engaged according to such an objective, it is assumed that SPEs are not under substantive control and are independent from the transferor. In addition, the transferor should recognize losses if the transferor bears losses when the value of assets of SPEs decreases, for example if the transferor holds subordinated interests issued by SPEs.

Under such situations, the transferor will cause the following problems if it consolidates above SPEs; a) while the SPEs' liabilities (including subordinated liabilities) are dependent only on the recourse from their own assets, the transferor shall recognize liabilities even though there is no obligation to pay additionally, and b) while the transferor accounts for assets transferred to SPEs as a sale appropriately and recognizes the losses for credit enhancement to SPEs at the time of sale, the transferor results in eliminating a gain or loss on sale and eliminating the losses on the subordinated interests on consolidated basis.

We believe that if we adopt an approach like IFRSs, the accounting treatment of derecognition of assets should be improved so that the IFRSs reflects the economics under such transactions.

### **B. Potential voting rights**

Under Japanese GAAP, as well as IFRSs, the scope of consolidation is determined based on control, i.e. not only voting rights but also whether the reporting company controls decision-making bodies of other entities or not. However, Japanese GAAP does not count potential voting rights explicitly like IFRSs. We believe that it is not appropriate to count

potential voting rights when they are unexercised, because holders of potential voting rights may be able to control the reporting company but has not done so yet.

Having said that, however, we believe that, taking into consideration other criteria (\*) for control under Japanese GAAP, a reporting entity effectively controls subsidiaries in many cases that it has a certain level of potential voting rights. When the reporting company has only minor voting rights (and in extreme cases, no voting rights) of entities but the above criteria are met, the reporting company should consolidate those entities. Thus, we believe that the difference between Japanese GAAP and IFRSs is not significant.

- (\*) Other criteria are a) a reporting company has a practical majority of voting rights, if we include the voting rights of parties that are closely related to the reporting company through investments, personnel, financing, technology and transactions, and parties who agree to exercising their voting rights concurring with the decisions of the reporting company, or b) there is an indication which enables the reporting company to control important financial, marketing and operating policy decisions, or fact which infers that reporting company controls the decision-making body.

### **3) Uniformity of accounting policies (IAS27)**

Under Japanese GAAP, in principle, uniformity of accounting policies is required for similar transactions and events under similar circumstances of subsidiaries. However, the JICPA Guideline also states that accounting policies applied to foreign subsidiaries in accordance with their local GAAP may be consolidated without adjustments, unless the difference in accounting policies will lead to unreasonable consequences.

The ASBJ is in the process of reviewing this exceptional but practically used treatment in Japan as one of the topics in the first phase of the joint project with the IASB and plans to issue the exposure draft by the end of this year.

We hope that the CESR will reconsider remedies on the uniformity of accounting policies based on the description above. In this regard, we also hope that the remedies if any are not applied retrospectively in the past financial statements, taking into consideration Japanese disclosure practice, which does not require retrospective adjustment as well as the practical cost of the remedy.

## **2. Disclosure C**

### **1) Date of exchange of business combination (IFRS3)**

Under Japanese GAAP, in an acquisition through an exchange of equity interests, the cost of the acquisition should be measured on the basis of the stock price prevailing during a reasonable period prior to the date when the major conditions for the business combination are publicly announced ('the date of public announcement'). However, if the stock price between the date of business combination and the date of public announcement is not significantly different, the cost of the acquisition is allowed to be calculated based upon the stock price on the date of business combination.

The reason for adopting, in principle, the stock price on the date of public announcement is as follows. Generally, the combining entities agree on the major conditions for the business combination, in particular the exchange ratio by reflecting the business value of each entity carefully. In fact, fluctuation in stock prices after the public announcement date may contain influence that is irrelevant to the underlying business value of the acquired entity.

The difference of date of exchange between Japanese GAAP and IFRSs affects the difference in the amount of goodwill. However, significant difference will not remain recorded on the balance sheet because goodwill is amortized every year under Japanese GAAP.

### **2) Negative goodwill (IFRS3)**

Under Japanese GAAP, it is considered that a rationale for the incurrence of negative goodwill is difficult to find and negative goodwill is assumed to be an adjustment element on the aggregate amount of the cost of the acquisition of the assets succeeded and should be regularly amortized symmetrically with positive goodwill. In addition, the disclosure of the amount of negative goodwill, the reasons for incurring it, and the amortization method and period are required to be disclosed in the note to financial statements.

We request that necessity of remedies should be reconsidered on the basis that the incurrence of negative goodwill seems to be rare and negative goodwill is booked on the balance sheet.

### **3) LIFO (IAS2)**

Cost formula of inventory is a basic recognition and measurement approach to account for non-financial (operating) investments. Some argue that the LIFO method imposes an unrealistic cost flow assumption for the measurement of profit and distorts the amounts of inventories in the

balance sheet. However, unless specific inventory flows are observable, we need apply a most plausible method among systematically defined methods. It seems that LIFO could be one of rational assumption of actual inventory flows along with FIFO and the average cost method.

For example, when the price of material goods have an immediate influence on the price of products or, when companies which import material goods and export final products face purchase and sales prices that fluctuate with foreign exchange rates, there could be a case that LIFO enables a reporting company to show its profit appropriately, which acts as useful information for investors.

#### **4) Uniformity of accounting policies in associates (IAS28)**

Under Japanese GAAP, uniformity of accounting policies in associates are encouraged but not required for similar transactions and events under similar circumstances. The reporting company has a certain influence on its associates but does not have enough power to control them. Typically, the reporting company cannot enforce unified accounting policies to its associates when they are subsidiaries of other companies.

#### **5) Capitalization of development costs (IAS38)**

Under Japanese GAAP, research and development costs, including costs incurred during the development phase, should be expensed when incurred. When research and development costs are incurred, it is difficult to foresee whether they will lead to profit. Even when a research and development plan advances, and probability of future profit increases, the realization of the future profit has still not been assured. It is also difficult to define objective and applicable criteria in practice. If abstract criteria were applied in deciding whether or not to capitalize the costs, comparability among business entities might be lost.

In business combinations, if the acquired assets include transferable intangible assets, the portion of costs of an acquisition is recognized as intangible assets. However, if the acquiring entity recognizes the costs of the acquisition as research and development costs, they are accounted for as expenses based on the point described above.

#### **6) Disclosure of amounts of financial assets and liabilities at fair value (IAS32)**

Under Japanese GAAP, trading securities, and available for sale securities are measured at fair value and the amounts of bonds held to maturities are required to be disclosed at fair value in the note to financial statements.

On the other hand, loans, receivables and financial liabilities are not within the scope of the

disclosure at fair value. Usefulness of disclosure at fair value of such financial assets and liabilities is questioned, because they are not marketable. In addition, it is doubtful that the disclosure of such financial assets and liabilities at fair value improve comparability and contribute to investors' decision making.

### **3. Disclosure A**

#### **1) Impairment of assets (IAS36)**

Under Japanese GAAP, the measurement of operating assets is considered to be unavoidably subjective because the proceeds from operating assets are uncertain, in contrast to financial assets whose future cash flow is fixed under contract. Therefore, an impairment loss is recognized and measured only when the occurrence of impairment is reasonably certain. The reversal of impairment loss is not permitted because such reversal is very unlikely and, even if it occurs, it would increase the clerical burden.

The 50% rule described in page 65 of the Draft Technical Advice is a treatment to judge whether market values of assets have declined. However, it is just one of indications of impairments. When the assets are likely to be impaired even if market values of assets have not declined by more than 50% of their book values or when there are other indications, the procedure of recognition and measurement of impairment should be carried out.

Therefore, we believe that the CESR should reconsider remedies for impairment of assets taking into account of the points explained above. In particular, the description that "the 50% rule might be used as most significant indicator for impairment" in page 65 of the Draft Technical Advice is not accurate because of the reason mentioned above.

#### **2) Cost method of inventories (IAS2)**

Under Japanese GAAP, inventories are measured at cost (cost method) or at the lower of cost and fair value. However, if the cost method is applied, the loss from write-down of inventories should be recognized when the fair value of inventories declines significantly.

In addition, as described above, the cost method of inventories is one of the topics for the first phase of the joint project with IASB. Therefore, the CESR should reconsider remedies for the cost method of inventories.



Finally, we hope that the CESR will reconsider remedies taking into account our comments on what rationale is present in respective differences.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Ikuo Nishikawa". The signature is fluid and cursive, with the first name "Ikuo" and the last name "Nishikawa" clearly distinguishable.

Ikuo Nishikawa  
Vice-Chairman, Accounting Standards Board of Japan

## Distinction whether the purchase method or the pooling of interests method is applied

