

May 29, 2009

The Accounting Standards Board of Japan

Release of “Discussion paper on possible improvements of the accounting for financial instruments”

Invitation to comment

Japanese GAAP for financial instruments include ASBJ statement No.10 “Accounting standard for financial instruments” (hereinafter, “ASBJ statement No.10”), JICPA Accounting System Committee Report No.14 “Practical guideline on accounting standard for financial instruments” (hereinafter, “the JICPA guideline”), and “Q & A on accounting for financial instruments” by JICPA.

Accounting Standards Board of Japan (ASBJ) issued the Tokyo Agreement with the International Accounting Standards Board (IASB) in August 2007. Based on this agreement the ASBJ has been undertaking its project to revise the existing Japanese GAAP for financial instruments. The project addresses such issues as the scope of items or transactions, measurement of financial instruments and hedge accounting.

On May 21, 2009, at the 177th board meeting, the ASBJ approved the release of the above mentioned discussion paper (hereinafter, “the DP”) for public comments.

The purpose of the DP is to invite public comments broadly. Those who have comments on the issues described in the DP are asked to send their comments in writing via e-mail by July 29, 2009. Please note that the ASBJ will not respond directly to individual comments, that comments are expected to be posted on the ASBJ’s website, and that comments without names of submitting persons or organizations are not treated as valid ones.

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Outline of the DP

Below is the outline of the DP prepared for the convenience of readers. Close attention to the original DP is strongly recommended, especially to those who intend to submit their comments.

Objective of the DP

The IASB is undertaking three long-term projects related to financial instruments ((a) Derecognition of financial instruments, (b) Financial instruments with characteristics of equity, (c) Replacement of IAS 39) and is working closely with the Financial Accounting Standards Board (FASB). The ASBJ's project which resulted in the issuance of the DP corresponds to the project (c) "Replacement of IAS 39". The objective of the DP is to discuss possible improvements of Japanese GAAP for financial instruments up until 2011. The IASB and the FASB have decided to proceed with their project expeditiously in response to the recent financial crisis.¹ They are planning to issue a related exposure draft this September or October. While the ASBJ is intending to contribute to this international effort based on the comments solicited through the DP, it will also continue to proceed with its own project.

[Issue 1] Scope of items and transactions within which the accounting for financial instruments is applied

[Issue 1-1] Definition of financial instruments

The IASB issued its discussion paper in March 2008 "Reducing Complexity in Reporting Financial Instruments" (hereinafter, "IASB's document"). IASB's document discusses the definition of financial instruments and items or transactions to which the accounting standards for financial instruments are applied. Considering these discussions, the DP compares the existing definitions of Japanese GAAP with those of the IFRS and describes matters to be considered in the future.

The definitions and the scope are considered similar between the Japanese GAAP and the IFRS, so this issue is not expected to be of high priority in the future discussion.

[Issue 1-2] Definition of a derivative

The DP discusses how a derivative should be defined in the accounting literature,

¹ On April 2009, the leaders of Group of Twenty (G20) countries recommended that the accounting standard setters appropriately respond to the financial crisis ((a) improvement of valuation and provisioning, (b) significant progress towards a single set of high quality global accounting standards) in an expedited manner in cooperation with the prudential supervisors and regulators. The IASB announced that it is committed to taking action on each of the items recommended by the G20 by the end of 2009 and is working intensively with the FASB and the ASBJ and other national standard-setters to achieve the objective of global convergence.

The IASB is planning to address the IAS 39 related issues separately, e.g. intending to accelerate the issuance of exposure draft on classification criteria in July on one hand but on the other hand to address hedge accounting in a separate exposure draft later this year.

including how such a character as net settlement should be taken into account. ASBJ statement No.10 lists typical derivatives in the definition of a derivative and the JICPA guideline supplements this definition by explaining the characteristics of a derivative. The ASBJ considers it appropriate to amend the definition of ASBJ statement No.10 by focusing on the characteristics of a derivative so that the amended definition is also applicable beyond typical derivatives.

While the JICPA guideline includes net settlement as one of the main characteristics of a derivative, the IFRS does not. If this makes little difference in practice, the issue on net settlement is not expected to be of high priority in the future discussion.

[Issue 2] Measurement of financial instruments

[Issue 2-1] Amendment of classifications

Existing classifications in the Japanese GAAP are, in their basic sense, similar to those of the IFRS. Both the IASB and the FASB are discussing the amendment of classifications and may eliminate or amend certain classifications taking into account responses to the IASB's document and the discussion after its issuance. Acknowledging this development, the DP discusses possible criteria to determine which instruments should be remeasured at fair value and considers specific possible amendments for some classifications.

One of the ways to determine whether certain investments are to be remeasured at fair value is to distinguish financial investments from operating investments by their nature. This is an existing treatment and may also remain a major criterion when developing future standards. In addition, the DP explains that IASB's document suggests such other criteria as the nature of cash flow of instruments (the variability of the cash flow) and the existence of active markets to trade the instrument. The ASBJ is intending to refine its view on classification criteria and contribute to the international efforts on this issue.

Taking into account current international development toward possible elimination of certain classifications, the DP discusses the possibility of reducing or eliminating available-for-sale category while placing emphasis on holding purposes (management intent) and the characteristics of financial instruments. The DP illustrates several possible amendments. The ASBJ considers it appropriate to explore this issue in the future.

In addition, if the classifications in IAS 39 remain almost unchanged as they are today, one possible amendment of Japanese GAAP is to provide "Loans and Receivables" classification. The ASBJ will consider whether to explore this issue in the future.

[Issue 2-2] Fair value option

The IFRS and US GAAP allow an entity to designate at initial recognition certain financial instruments to be measured at fair value with its change in profit or loss (so called, fair value option).

The DP shows some proponent views for and opponent views against fair value option. Both the IASB and the FASB are discussing the amendment of existing classifications and this discussion may affect whether fair value option continues to exist in the future. The ASBJ will consider whether to explore this issue in the future taking into account such international development.

[Issue 2-3] Reclassification

The ASBJ issued Practical Issues Task Force No.26 “Tentative Solution on Reclassification of Debt Securities” in December 2008. It allows certain reclassification as a tentative treatment. The DP discusses whether this treatment should be continued given that the existing classifications remain unchanged as they are now.

The PITF No.26 was issued as one of the measures to address recent financial crisis in an expedited manner. The ASBJ will consider whether this treatment should be continued.

In particular, as to the reclassification from available-for-sale securities to held-to-maturity ones, the ASBJ considers it appropriate to discuss whether the reclassification should not be limited to rare circumstances. In that case, the ASBJ will take into account the concept of reclassification and the international development regarding classifications of financial instruments.

[Issue 2-4] Impairment

Impairment is understood as the treatment to reduce the carrying amount of assets when the amount is not likely to be recoverable due to the decline of their profitability. On the other hand, there are differences in the treatment of impairment between the IFRS and US GAAP or within their own standards. The IASB discusses its recognition criteria (triggers) and necessity of reversal. The DP discusses following three items.

(1) Impairment of securities

Whether the recognition criteria need to be improved is being discussed internationally as one of the measures for the recent financial crisis. Acknowledging this, the DP discusses the meaning of impairment, its recognition criteria, measurement of impairment loss, and impairment of investment in subsidiaries and associates.

(2) Impairment of receivables

The ASBJ considers it appropriate to explore how to measure impairment loss taking into account the related international development.

(3) Accounting treatment after impairment

There are two different methods of presentation for the decline of carrying amount of assets, one of which is to directly reduce the carrying amount (direct reduction), and the other of which is to use an allowance account (indirect reduction). In Japan, the former treatment is

generally regarded as impairment. On the other hand, in the IFRS, these two methods are not essentially different other than in their presentation. Moreover, there are some discussions that the impairment loss should be reversed when the fair value of an instrument recovers. The ASBJ considers it appropriate to explore the issue of whether to allow reverse of impairment along with the above mentioned issues such as the meaning of impairment and its recognition criteria.

The ASBJ will consider whether to explore the issue of how to recognize interest revenue after impairment in the future taking into account problems in practice.

[Issue 2-5] Bifurcation of hybrid instruments

Japanese GAAP requires bifurcation of an embedded derivative in the hybrid financial instrument if its host financial asset or financial liability is exposed to the risk of the embedded derivative. However, the IFRS and US GAAP require such bifurcation if the economic characteristics and the risk of an embedded derivative are clearly and closely related to those of its host contract.

The ASBJ will consider whether to explore this issue in the future.

[Issue 3] Hedge Accounting

[Issue 3-1] The meaning of hedge accounting

The DP discusses the meaning of hedge accounting, types of hedging transactions, and the scope of hedged risk in the hedge accounting.

IASB's document explains removing entire hedge accounting as one possible way to reduce complexity. However, entire removal may not be considered appropriate, so the DP assumes that the hedge accounting continues.

There is not much difference in the meaning of hedge accounting, etc. between the Japanese GAAP and the IFRS. Thus, the issues in this subsection are not expected to be of high priority in the future discussion.

[Issue 3-2] Accounting treatment of hedging transactions

The DP summarizes the existing accounting treatments of hedging transactions and discusses possible improvements.

IASB's document shows possible ways to improve fair value hedge accounting. Out of these possibilities the DP selects two ways ((a) extended use of fair value option and (b) application of deferral accounting) and sorts out their advantages and disadvantages. The ASBJ considers it appropriate to explore how to improve fair value hedge accounting taking into account the related international development as well as how to contribute to the international efforts.

The exceptional treatment of a hedging transaction using an interest rate swap and the assignment method for a foreign currency exchange contract adopted in the Japanese accounting standards may fall under the scope of so-called synthetic instrument accounting. The ASBJ considers it appropriate to explore the issue of whether to retain these types of exceptional treatments, focusing on whether under certain limited circumstances the hedged item and a hedging instrument should be treated as if they were a single instrument. The ASBJ will also take into account the influence on the practice the possible change might have and convergence toward the IFRS.

[Issue 3-3] Possible simplifications of hedge accounting

The DP highlights the need to consider the simplification of hedge accounting as suggested in IASB's document. The DP considers possible simplifications in the following aspects provided that the existing hedge accounting continues to exist:

- (1) Documentation
- (2) Effectiveness
- (3) Dedesignation
- (4) Partial hedge

There seems to be little room for improvement in the aspects (1) and (4). Regarding the aspect (2) the improvement by mitigating hedge effectiveness criteria seems worth further exploration, but should be considered with the recognition of ineffectiveness. The possible simplifications in the aspect (3) may be studied with the issue of reclassification (see [Issue 2-3]), where the objective of classification considering the holding purpose of financial instruments may need to be balanced with the exclusion of arbitrariness.

[Issue 3-4] Portfolio hedge

The DP summarizes the existing requirements of portfolio hedge accounting and considers possible improvements and simplification.

Following the related international development, the ASBJ will consider whether to explore the issue of possible mitigation of the portfolio hedge accounting criteria as well as how to contribute to the international effort.

[Issue 3-5] Disclosure requirements related to hedge accounting

The DP summarizes the existing disclosure requirements of hedge accounting and considers possible improvements of the Japanese GAAP.

The Japanese GAAP provides similar disclosure requirements to those of the IFRS regarding qualitative information such as the objective to use derivatives. However, difference still exists in some items of quantitative information, so the ASBJ considers it appropriate to explore

whether to amend the disclosure requirements related to such information.

<Questions to respondents>

(Omitted)