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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Comments on the Exposure Draft of *Financial Instruments: Classification and Measurement*

To the Board Members:

The Japanese Institute of Certified Public Accountants appreciates the continued efforts of the International Accounting Standard Board (IASB) on the financial crisis and welcomes the opportunity to comment on the exposure draft of *Financial Instruments: Classification and Measurement*.

This exposure draft proposes to significantly change the current provisions and the framework of IAS 39. As such, we request the IASB to give sufficient consideration in preparing the final standard not only to comments on the current exposure draft, but also to comments on other exposure drafts on impairment and hedge accounting scheduled to be proposed later.

The following is our response to the items in 'invitation to comment' with which we disagree or have questions or concerns.

Classification approach

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has ‘basic loan features’ and ‘is managed on a contractual yield basis’? If not, why? What additional guidance would you propose and why?

Comment:

We believe that there is insufficient guidance on the determination of whether an instrument "is managed on a contractual yield basis." Therefore, it is necessary for the IASB to provide additional guidance for further clarification.

Paragraph B9 of the exposure draft states: "Financial instruments are managed on a contractual yield basis only if they are managed, and their performance evaluated by the entity’s key management personnel, on the basis of the contractual cash flows." Paragraph B10 further states: "Whether financial instruments are managed on a contractual yield basis does not depend on management’s intentions for an individual instrument. It depends on how management manages the instruments." In other words, paragraphs B9 and B10 of the exposure draft state to the effect that whether financial instruments are managed on a contractual yield basis should be judged not based on an instruments-by-instruments approach, but based on how they are managed by the management, i.e., the business model.

However, whether to sell such financial instruments is a matter of the management’s judgment based on their holding purpose, which may from time to time override the business model in practice. In addition, although the proposed approach focuses on managing financial instruments based not on a market price but on a contractual yield alone, given that the judgment on asset or economic capital allocation to each business unit in itself depends on the market environment, it is merely one aspect of the business model.

Furthermore, in a Q&A session held on July 22, 2009, the IASB staff noted that when a portfolio is "held for the purpose of sale in a favorable market environment," it is doubtful that the portfolio is managed on a contractual yield basis. In fact, especially in major financial institutions, not only trading portfolios, but also other-than-trading bond portfolios are, in some cases, expected to be held for the purpose of selling a certain portion thereof in a favorable market environment. As such, we fear that the actual management practice of managing a portfolio for multiple purposes is not clearly reflected in the approach proposed by the exposure draft.

For these reasons, we believe that the IASB needs to provide clear additional guidance to allow reporting entities to reflect the above-mentioned management practice in their determination of whether financial instruments are managed on a contractual yield basis. If such additional guidance cannot be provided, concerns will remain that the original purpose of avoiding confusion in the practical application of the standard may not be attained.

Embedded derivatives

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decisionusefulness of information about contractually subordinated interests?

Commnet:

(a) We basically agree that such requirements should be eliminated. However, we believe that it is desirable also to keep the current provisions of IAS 39 so that reporting entities can make their own choice whether to bifurcate such contracts. In particular, we believe that, with respect to hybrid financial instruments classified as liabilities, it is desirable to make a final conclusion only after a thorough examination is completed as to whether fair value measurement of them should incorporate own credit risk.

(b) As argued in paragraphs BC26 through BC28 of the exposure draft which notes that the approach to look through to the underlying assets of a structured investment vehicle would not work for debtors other than those with a narrow investment scope, it may be extremely difficult to judge whether credit protection is provided based on the existence of collateral (i.e., whether it has precedence) especially in the case of financial instruments other than structured investment products depending on the legal system of each nation. This also implies that from the perspective of theoretical consistency, the same assessment will be required for ordinary loans (debts). As this issue also relates to the discussion on the distinction between liabilities and equity, we believe that it is desirable to revisit this issue only after further examination of the discussion on equity/liabilities distinction is conducted.

Fair value option

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

Comment:

In cases where, for example, the proposed condition that the financial instrument "is managed on a contractual yield basis" is not included in the final standard or the bifurcation requirements of embedded derivative for a hybrid contract with a financial host are not eliminated from the final standard as proposed by the exposure draft, the fair value option permitted by the current IAS 39 should also be permitted by the new standard.

Reclassification

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

Comment:

As currently proposed in the exposure draft, the condition that the financial instrument "is managed on a contractual yield basis" depends on how management manages the instrument (i.e., the business model of the reporting entity). Such management method may be changed in a medium/long term period. As drastic changes in the market condition as in the case of the recent financial crisis are likely to happen again, we believe that reclassification under limited circumstances should be permitted.

Investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Comment:

We agree that measuring investments in equity instruments at fair value will provide decision-useful information to the extent that they can indeed be measured at fair value. However, there may be cases (e.g, ownership percentage in the investee is quite small) where so little information is available that fair value cannot be measured reliably. We consider that uniform application of fair value measurement to such cases will not necessarily lead to decision-useful information.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Comment:

As indicated in the comment to Question 8, in cases where little information is available for fair value measurement, usefulness of requiring fair value measurement is expected to be limited as the reliability of such measurement is extremely low. In addition, with respect to investments not made for the purpose of seeking increase in the value of the investment as in the case of "strategic investment" discussed in BC68 of the exposure draft, the benefits of fair value measurement are relatively limited due to their holding purpose and we expect that there are not many circumstances in which the benefits of measuring such investments at fair value outweighs its cost. In such cases, net asset value or similar measurement may be used as substitute for fair value.

Investments in equity instruments that are measured at fair value through other comprehensive income

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

Comment:

We believe that determining the appropriate accounting treatment based on the holding purpose would provide accounting information useful for the users' assessment on the business activities of the reporting entity and improve financial reporting.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why? (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Comment:

We agree that the proposed treatment should be permitted only if an entity made such election at initial recognition provided that the accounting treatment is consistent with the holding purpose of the entity. In addition, in order to eliminate arbitrary application of accounting treatments, requirements concerning the holding purpose and other attributes should be established with respect to investments that are eligible for such election.

In cases where there is a change in the management's holding purpose subsequent to the initial recognition, it is also consistent that the election rule permits a corresponding change in the measurement category. On the other hand, in order to eliminate arbitrary application of accounting treatments, changes in the holding purpose should be permitted only in limited circumstances such as changes in the external environments, the investment policy and the guidance on such restriction needs to be provided. We also believe that the IASB should clearly prescribe that in this case, difference between fair value and carrying amounts at the time of the change in the measurement category should not be recycled and only the difference arising thereafter should be reflected in profit or loss.

Effective date and transition

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

Comment:

Although the exposure draft permits reporting entities to choose a date of initial application not falling on the beginning or ending date of the reporting period, we believe that from the perspective of eliminating arbitrary application of accounting treatments, it is appropriate to uniformly require the date of initial application to be the beginning date of a reporting period including the case of early adoption (in this case, it should also be required that classification and determination of the category has been completed at the beginning date of the reporting period).

An alternative approach

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically: (a) in the statement of financial position? (b) in the statement of comprehensive income? If so, why?

Comment:

Under the alternative approach indicated in the exposure draft, a measurement method that is inconsistent with the holding purpose may be adopted. For example, with respect to bonds and other instruments with an active market that do not satisfy the definition of "loans and receivables" prescribed by IAS 39, fair value measurement may be applied even in the case where they are held by the management for the purpose of obtaining interest revenue. As a result, the aim of providing accounting information useful to the users' assessment on the business activities of the reporting entity may not be fulfilled. We also fear that complexity will remain in the determination of whether a financial instrument satisfies the requirement for the availability of quoted price in an active market.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

Comment:

We believe that under either of the two possible variants of the alternative approach, a measurement method that is inconsistent with the holding purpose of the management may be adopted, and as a result, the aim of providing accounting information useful to the users' assessment on the business activities of the reporting entity may not be fulfilled.

Yours faithfully,

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Executive Board Member－Accounting Standards
The Japanese Institute of Certified Public Accountants