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International Accounting Standards Board
30 Cannon Street
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Comments on the Discussion Paper of Financial Instruments with Characteristics of Equity

To the Board Members:

The Japanese Institute of Certified Public Accountants appreciates the continued efforts of the International Accounting Standard Board (IASB) on the liabilities and equity project and welcomes the opportunity to comment on the discussion paper of Financial Instruments with Characteristics of Equity.

The following is our response to the items in 'invitation to comment', including those asked in the FASB Preliminary Views document, with which we disagree or have questions or concerns.

Questions on the Basic Ownership Approach

Question2

Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

Comment

Under the basic ownership approach, preferred shares and certain other instruments would be classified as liabilities as opposed to the current practice under which they are classified as equity. This would have an impact on various systems and rules, and require corresponding adjustments to them. For instance, in Japan, as we will point out under Additional Question B3, the amount of equity required to be recognized under the statutory rules would differ from the amount of equity recorded for financial accounting purposes. Therefore, some kind of arrangement for reconciling the discrepancy will be required. We also believe that the measurement issue as mentioned in Question 3 would be one of the major operational concerns.

Question3

The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

Comment

With respect to paragraph 34(b), we believe that there are only limited circumstances in which fair value can be reasonably measured for instruments that are currently classified as equity. Therefore, we expect that there will be concerns about the reasonableness of the measurement with respect to certain instruments if all the perpetual instruments to be classified as liabilities under this approach would be required to be remeasured at fair value. We also believe that recognizing in profit or loss in each reporting period changes in the fair value of perpetual instruments for which no redemption is expected would not necessarily be useful to users of financial statements.

With respect to paragraph 34(c), we believe that there are only extremely limited circumstances in which an expected dividend stream and an expected retirement date can be reasonably determined. Therefore, although it can be useful as possible alternative, we believe that it is not suitable as a principle method. In addition, in cases when this method is adopted, we have same concerns as discussed in relation to paragraph 34(b), that is, whether changes in the fair value arising from subsequent remeasurement to be recognized in profit or loss would provide useful information with users of financial reporting.

Question4

Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

Comment

With respect to paragraph 20(b), we believe that there are only limited circumstances in which redemption of a basic ownership instrument would have no adverse impact on the claims of financial instruments with higher priority than the basic ownership instrument. Accordingly, we do not believe that it would be easy to determine what would be the acceptable level.

Question5

A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

Comment

We believe that it is unclear exactly what kind of instrument the term "a basic ownership instrument with a required dividend payment" is referring to. In Japan, dividends on stocks are finally declared upon the approval of the governing body. No legal or constructive liability for the company to pay dividends normally exists before such approval. Therefore, the liability component should not be recognized.

Question6

Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

Comment

We believe that the substance principle is necessary under the basic ownership approach which would provide clear criteria, since classification based solely on the form would not be able to preclude the opportunity for structuring completely. For the effective operation of the approach, it would be necessary to provide sufficient case examples to be determined on the basis of the economic substance, including guidance on structuring examples, on an ongoing basis.

Question7

Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

Comment

In order to minimize the opportunity for structuring, we believe that it is necessary to set the linkage principle for the reason mentioned in the response to Question 6. For the effective operation, we believe that it is necessary to ensure consistency with the bifurcation of hybrid financial instruments, in which a derivative instrument is embedded, and to refine and improve practical guidance.

Question8

Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

Comment

We believe that it is necessary to deliberate sufficiently whether the financial instruments to be classified as liabilities under the basic ownership approach are derivatives. It would also be necessary to deliberate sufficiently whether changes in fair value of those instruments are recognized in profit or loss, that is, reported in net income.

As stated in paragraph 67 of the FASB document, under the current GAAP, a written option to issue a basic ownership instrument (e.g., a written call option on common stock that is a basic ownership instrument) is usually classified as equity. On the other hand, these options would be classified as liabilities under the basic ownership approach, as they no longer meet the definition of a basic ownership instrument. We believe that sufficient deliberation has not been made as to whether it is useful for users of financial statements to require measurement of such instruments classified as liabilities at fair value and to recognize changes in value in profit or loss, reported in net income.

Question9

Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity’s potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

Comment

We agree that basic ownership instruments with redemption requirements should be reported separately from perpetual basic ownership instruments.

We also believe that liabilities requiring settlement with equity instruments should be reported separately from those required to be settled with cash.

In addition, since we believe that only disclosure of such information in the notes to financial statements may possibly achieve the intended purpose of the separate display as stated in the Question, without change of presentation requirement, the possibility of such note disclosure requirement should be explored in developing accounting standard.

Question10

Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

Comment

We believe that it is not an issue unique to financial instruments with characteristics of equity how to display the effects on net income that are related to the changes in the financial instrument's fair value, but pervasive to financial instruments in general. Therefore, we believe it appropriate to discuss this issue related to financial instruments in general, rather than in this Discussion Paper.

Question11

The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Comment

We believe that it is appropriate for the Board to consider, for instance, the following issues:

- treatment of gains or losses to be recognized in relation to dividends for a basic ownership instrument in cases when the dividends are recognized as liabilities; and,
- how to reflect the dilutive effect of options in the EPS calculation.

Questions on the Ownership-Settlement Approach

Question1

> Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

Comment

We believe that as compared with the basic ownership approach, the ownership-settlement approach would not contribute a great deal to the improvement of financial reporting.

Questions on the REO Approach

Question1

> Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.

Comment

We believe that as compared with the basic ownership approach, the REO approach would not contribute a great deal to the improvement of financial reporting.

Appendix B: Additional Questions for Respondents

Additional Question B1 (a)

Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?

(a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

Comment

We believe that the basic ownership approach is an appropriate starting point for a project to improve or simplify IAS 32. However, in addition to the issues already mentioned above, the Board needs to resolve the following issues.

- Under the basic ownership approach, the number of financial instruments classified as equity would be extremely limited as compared with the current practice, and a number of financial instruments would be classified as liabilities. Certain financial instruments newly classified as liabilities by the adoption of the basic ownership approach do not meet the current definition of a liability. Therefore, the Board needs to ensure the consistency between the approach and the definition of a liability as provided in paragraph 16 of IAS 32.
- The problem inherent in the subsequent measurement of perpetual instruments other than basic ownership instruments has not been resolved.

  As indicated in the FASB Preliminary Views document, having two approaches other than the basic ownership approach (i.e., the ownership-settlement approach and the REO approach) are excessively complex and their practicality appears to be limited.

Additional Question B3 and B4

B3 Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

B4 Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance.) If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

Comment

In Japan, the amount of equity recorded for financial reporting purposes under the basic ownership approach would differ from those to be recognized under the Companies Act. Therefore, we expect that an arrangement for reconciling the discrepancy between the accounting requirement and legal requirement will be required.

In addition, for certain regulated industries such as financial institutions that are subject to regulations based on equity capital indicators, an arrangement for reconciling the discrepancy between the amounts of equity recorded for financial reporting purposes and those as regulatory capital will be required.

Although it cannot be argued that the principles behind the basic ownership instrument are inappropriate, under the Companies Act of Japan, the definition of shareholders' equity is determined by whether the holder has a claim to residual assets remaining as a result of the activities of the company, rather than focusing on claims to the lowest residual assets. Therefore, preferred shares, which are classified as shareholders' equity under the Companies Act of Japan, do not meet the definition of a basic ownership instrument. We expect that such difference will necessitate the introduction of arrangement for the reconciliation with the legal requirements.

Yours faithfully,

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