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

Dear Sir David:

re: Comments on "Financial Instruments with Characteristics of Equity"

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on the International Accounting Standards Board (IASB or the Board)'s discussion paper "Financial Instruments with Characteristics of Equity". The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members exceed 22,000. The CAC is a standing committee of the SAAJ composed of 13 members, most of whom are users including equity and credit analysts, and portfolio managers, while a few others are academicians, and public accountants. Before drafting this comment letter, the SAAJ sponsored a study session on the discussion paper, inviting three ASBJ (the Accounting Standards Board of Japan) staff as lecturers. Some 106 certified members of the SAAJ participated in the session. A questionnaire was subsequently sent to session participants and 73 responded, making for a 69% response ratio. This comment letter takes full consideration of the views expressed in the questionnaire replies as well as discussion among CAC members. The survey results, quoted from time to time in the following comments, are attached to this letter.

1. General Comments

(1) Valuation of liabilities

The IASB's discussion paper and the Financial Accounting Standards Board (FASB)'s preliminary views on "Financial Instruments with Characteristics of Equity" seem to assume financial liabilities be marked to market. We agree with the fair value measurement of financial liabilities for financial institutions and companies with significant exposure in financial operations, whose source of profits comes from the mismatching of financial assets and liabilities in terms of duration and/or credit risks. In these cases, it is rational to apply the same valuation method to corresponding items

on the left and right side of the balance sheet.

For general corporations, except the ones mentioned above, financial liabilities are typically assumed in order to purchase physical assets needed for business. Here, if we take the stance of applying the same valuation to corresponding items located on the left and right side of the balance sheet, and if we mark financial liabilities to market, then we have to mark, say, the manufacturing facilities for which the liabilities were borrowed. This will incur onerous problems such as how to value real estate and factories, and whether intangible assets associated with production facilities should be valued or not.

Also, as the financial liabilities assumed for finance business assets are often refinanced, it leads us to doubt the significance of recognizing interim market value changes with respect to those elapsing financial liabilities. In addition, there is the famous paradox of credit ratings. In the above-mentioned survey, the majority were against applying fair value measurement to financial liabilities, as shown below.

Q2: In general terms, do you agree or disagree with marking financial liabilities (loans, bonds, etc.) to market and recognizing valuation gains and losses as part of a company's performance?

A2:

Agree	*18*	*25%*
Disagree (In the revised Japanese standards, the market value of financial liabilities is already required to be disclosed in a note to financial statements, which provides enough information for analysis.)	*46*	*63%*
Other	*9*	*12%*

The discussion paper also assumes the market valuation of derivatives and preferred shares, but we are not convinced that such valuation of these liability instruments is inevitable, except those held for trading purposes. FASB preliminary views do not make it clear where valuation gains/losses relating to financial liabilities should be shown, in net income or in other comprehensive income. Although we understand this is primarily due to the limitation caused by the timing of the publication, we respectfully ask the Board to clarify how these gains/losses should be reported in the forthcoming discussion paper. It is our belief that the classification of liabilities and equities and resulting valuation issues should be considered as a package and not in isolation. Deliberation as

detailed as in your discussion paper on "Preliminary Views on Amendments to IAS 19 Employee Benefits" is necessary. In our survey, the majority mentioned valuation gains/losses should be shown in other comprehensive income if financial liabilities are marked to market.

(2) Is the dichotomy approach appropriate?

The discussion paper assumes that the credit side of the balance sheet is divided into liabilities and equity, a very clear cut method. We think, however, there is a room for reconsideration because (1) there are financial instruments with characteristics of both equity and liabilities, (2) the dichotomy affects valuation, and (3) each country has its own legal definition of capital. For example, a non-dichotomy approach is being introduced in Japanese standards where the credit side of the balance sheet except liabilities is called 'net assets' which is divided into stockholders equity and 'others' (valuation differences, warrants/options, and minority interests). Setting up a mezzanine account between liabilities and equity needs to be studied as another approach.

2. Comments on FASB's Preliminary Views

Questions on the Basic Ownership Approach

1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

We think the basic ownership approach encompasses many issues that should be deliberated further, but, bearing in mind the increasingly complicated financial products being introduced, it is nevertheless headed in a better direction than the current standards. Therefore, we basically support the approach. Compared to other approaches, the basic ownership approach clearly distinguishes between liabilities and equity, has little room for possible manipulation by preparers, and contributes to simplifying accounting proceedings.

However, many committee members raised concern with respect to the wide gap between the proposal and current Japanese standards and legal framework. They are particularly uncomfortable with preferred shares being classified as liabilities, as, under Japanese corporate law, they are regarded as equity.

In our survey shown below, "Agree" with the basic ownership approach outnumbered "Disagree", but did not get a majority.

Q1: FASB's preliminary views 'Financial Instruments with Characteristics of Equity', introduces the basic ownership approach (BOA) as the appropriate method under which the most residual claim is classified as equity, basically meaning only common shares can be regarded as equity. Do you agree or disagree with this view?

A1:

Agree	*36*	*49%*
Disagree	*29*	*40%*
Other	*8*	*11%*

Perpetual Instruments

2. 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?

The CAC's opinions were divided in regard to classification of preferred shares as liabilities. Those concurring said that since the basic ownership approach limits equity to only common shares, it is natural for preferred shares to be regarded as liabilities. Reclassification of preferred shares as liabilities will lower the equity to total assets ratio, but supporters assert it is not an issue as easy adjustments will solve the problem.

Some members raised concern regarding the influence on the banking industry. In Japan, many of the major issuers of preferred shares are banks. When preferred shares are classified as liabilities, the equity to total assets ratio of these banks may decline rather significantly. This may have repercussions with BIS regulators, or the Basel Committee on Banking Supervision. These members mentioned that they cannot make a final decision until they know how BIS might react.

3. 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.

On the three methods proposed under paragraph 34, we prefer "*a. Do not remeasure, but report dividends as an expense either when declared or at regular intervals (if dividends are normally paid each period)*". However, some members prefer "*Remeasure at fair value with changes reported in other comprehensive income*", while others think the current method is enough for preferred shares.

Measurement

8. 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?

If credit side derivatives were held for trading purposes, it is reasonable to remeasure them. However, it would be rare to issue warrants and/or options for trading purposes. The value of warrants and options will move in tandem with the value of common shares. When the price of the common shares goes up, the value of the above-mentioned derivatives also goes up, and, if you mark them to market, liabilities increase, impairing equity. On the other hand, the decline in common share price will replenish equity. In order to avoid this serious paradox, pluralistic valuation according to holding purpose should be taken rather than a blanket approach to remeasurement of all derivatives.

Presentation Issues

9. *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?*

As mentioned in "*1. General Comments (2) Is the dichotomy approach appropriate?*" above, we think setting up a mezzanine account between liabilities and equity or a sub-account in broadly-defined equity might be necessary. Therefore, we feel the

question of "*additional separate display for the liability section*" is too narrow in scope and urge the Board to consider the matter from a broader perspective.

10. 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.

As mentioned in "*1. General Comments (1) Valuation of liabilities*" above, we are, in principle, against the remeasurement of financial liabilities, and, if remeasurement is introduced, we think valuation gains and losses should be included in other comprehensive income. One exception might be derivatives held for trading purposes to which fair value measurement should be applied both for assets and liabilities.

Earnings per Share (EPS)

11. 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?

By remeasuring financial liabilities, market value changes that have little prospect of being realized would be reflected in EPS, making it a volatile number far from the reality of recurring business activities. Huge EPS fluctuations of this kind are not desirable. Our survey evidences clear concern regarding EPS.

Q6-1: Based on the philosophy presented in the discussion paper, if financial liabilities, including preferred shares, are marked to market and valuation differences recognized in net income, some performance measures, for example EPS, may fluctuate significantly each period. What do you think of this?

A6-1:

Natural, as it reflects risks.	*16*	*22%*
Huge fluctuations are not desirable.	*47*	*64%*

Other	*10*	*14%*

Q6-2: Even when financial liabilities, including preferred shares, are marked to market, if valuation differences are directly reflcted in equity, EPS fluctuations could be smaller. What do you think of this?

A6-2:

Desirable as huge fluctuations will be eliminated.	*51*	*70%*
Not desirable as risks will not be reflected.	*8*	*11%*
Other	*14*	*19%*

3. Conclusions

We would like to highly commend IASB and FASB's efforts to establish clear cut standards in the circumstances where diversified financial products are spawning and immediate convergence of accounting standards is an imminent issue. In addition to improving the basic ownership approach, there are many issues that need to be resolved to establish a single set of accounting standards that are accepted and used around the globe. The Corporate Accounting Committee is committed to following the developments in IFRS and will offer constructive opinions and proposals. Should you have questions or need clarification, please contact Mr. Sei-Ichi Kaneko, Executive Vice President, SAAJ (s-kaneko@saa.or.jp).

Sincerely yours,

Keiko Kitamura
Chair
Corporate Accounting Committee

APENDIX

SAAJ Survey Results on 'Financial Instruments with Characteristics of Equity'

Background and methodology

The Securities Analysts Association of Japan (SAAJ) sponsored a study session on IASB's discussion paper 'Financial Instruments with Characteristics of Equity', inviting three staff of the Accounting Standards Board of Japan (ASBJ) as lecturers. Some 106 certified members of the SAAJ participated in the session held on 11th June. A questionnaire was subsequently sent to session participants and 73 responded, making for a 69% response ratio. The respondents could also add comments regarding each question. The survey, although small in terms of the number of questionnaires distributed, focused on a cohort with the same background (certified members of the SAAJ) and same knowledge level (participation in the study session). This focus and very high response rate gives credibility to the reliability of the survey.

Survey questions and answers and comments by SAAJ analysts

Q1: FASB's preliminary views 'Financial Instruments with Characteristics of Equity', introduces the basic ownership approach (BOA) as the appropriate method under which the most residual claim is classified as equity, basically meaning only common shares can be regarded as equity. Do you agree or disagree with this view?

A1:

Agree	36	49%
Disagree	29	40%
Other	8	11%

Summary: Opinion divided between 49% "Agree" and 40% "Disagree".

Many respondents who agreed said the approach was 'easy to understand with little room for arbitrary treatment'. Those who disagreed cited 'lack of continuity and too different from current standards', 'too complicated to implement', and 'certain financial instruments other than common shares should be regarded as equity'. Some raised concern on the possible repercussions with BIS regulators, or the Basel Committee on Banking Supervision.

Q2: In general terms, do you agree or disagree with marking financial liabilities (loans, bonds, etc.) to market and recognizing valuation gains and losses as part of a company's performance?

A2:

Agree	18	25%
Disagree (In the revised Japanese standards, the market value of financial liabilities is already required to be disclosed in a note to financial statements, which provides enough information for analysis.)	46	63%
Other	9	12%

Summary: The majority disagreed. Answers to Q1 had little relevance to this result as 61% of those agreeing and 66% of those disagreeing with Q1, disagreed with Q2.

Many who agreed reasoned 'if financial assets are marked to market, so are liabilities'. Major reasons of those disagreeing were 'the objectives of fair value measurement of financial liabilities are unclear', 'oppose to fair value measurement, even for financial assets', 'credit rating paradox', 'would induce unnecessary volatility in performance', and 'would mislead investors'. Many who answered "Other" had similar comments as for "Disagree".

Q3: If valuation differences are to be reflected in a company's performance, should they be included in net income, or should they be directly reflected in equity (valuation differences)?

A3:

Net income	8	11%
Direct reflection in equity (valuation differences)	60	82%
Other	5	7%

Summary: Direct reflection got predominant support. Again, answers to Q1 had little relevance as 83% of those agreeing and 79% of those disagreeing with Q1, supported direct reflection.

Many who supported direct reflection cited 'including temporary gains and losses in net income obscures a company's performance in terms of its recurring business activities' and 'net income inclusion will cause unnecessary volatility in performance'.

Q4: According to the discussion paper, preferred shares, warrants, and stock options are all classified as liabilities and thus subject to fair value measurement. Do you agree or disagree?

A4:

Agree	24	33%
Disagree (Fair value shown in a note is enough.)	40	55%
Other	9	12%

Summary: "Disagree" (55%) outnumbered "Agree" (33%). The answer was influenced by the response to Q1. 56% of those agreeing with Q1 (BOA supporters) agreed with Q4, while 72% of those disagreeing also disagreed with Q4. Many who chose "Other" said they agreed to fair valuing some products but not others mentioned in the question.

Q5: If preferred shares, warrants, and stock options are subject to fair value measurement as liabilities, should valuation differences be included in net income, or should they be directly reflected in equity (valuation differences)?

A5:

Net income	7	10%
Direct reflection in equity (valuation differences)	59	80%
Other	7	10%

Summary: Direct reflection supporters (80%) overwhelmed net income supporters. Answers to Q1 were irrelevant as 83% of those agreeing and 79% of those disagreeing with Q1, supported direct injection.

Reasons for supporting direct reflection were similar to Q3, 'including temporary gains and losses in net income obscures a company's performance in terms of its recurring business activities' and 'net income inclusion will result in unnecessary volatility in performance'. Some who chose "Other" said they were against fair value measurement per se.

Q6-1: Based on the philosophy presented in the discussion paper, if financial liabilities, including preferred shares, are marked to market and valuation differences recognized in net income, some performance measures, for example EPS, may fluctuate

significantly each period. What do you think of this?

A6-1:

Natural, as it reflects risks.	16	22%
Huge fluctuations are not desirable.	47	64%
Other	10	14%

Summary: "Huge fluctuations are not desirable" took the lion's share (64%). Answers to Q1 influenced A6-1 to some extent. 31% of those agreeing with Q1 (BOA supporters) chose "Natural, as it reflects risks", while 72% of those disagreeing chose "Huge fluctuations are not desirable".

Those who answered "Natural, as it reflects risks" cited 'accounting principles should not be compromised by possible fluctuation of EPS' and 'natural extension of the discussion paper's philosophy'. "Huge fluctuations are not desirable" supporters mentioned 'valuation gains and losses have a tenuous relationship with the actual performance of companies', 'impossible to interpret the meaning of EPS', and 'induces unnecessary confusion among investors'.

Q6-2: Even when financial liabilities, including preferred shares, are marked to market, if valuation differences are directly reflected in equity (valuation difference), EPS fluctuations could be smaller. What do you think of this?

A6-2:

Desirable as huge fluctuations will be eliminated.	51	70%
Not desirable as risks will not be reflected.	8	11%
Other	14	19%

Summary: "Desirable as huge fluctuations will be eliminated", received majority support (70%). 69% of those agreeing with Q1 and 72% disagreeing supported "Desirable", suggesting Q1 had little impact on this question. Similar reasons to Q6-1 were mentioned.

Q7: According to the discussion paper, most preferred shares will not be regarded as equity, lowering the equity to total assets ratio at the time of the change. What do you think about this?

A7:

Natural from the viewpoint of common stock owners.	14	19%
Not desirable from the viewpoint of data continuity.	14	19%
Doesn't matter, make adjustments when necessary.	35	48%
Other	10	14%

Summary: "Doesn't matter, make adjustments when necessary" received nearly half of the vote (48%). Answers to Q1 had some relevance. Amongst those who answered "Agree" to Q1 (BOA supporters), 58% supported "Doesn't matter", and another 33% chose "Natural from the viewpoint of common stock owners". Amongst those who answered "Disagree", 38% voted for "Not desirable from the viewpoint of data continuity", while 31% chose "Doesn't matter".

"Natural from the viewpoint of common stock owners" respondents thought preferred shares were more like liabilities than equity. "Not desirable from the viewpoint of data continuity" supporters were concerned about possible significant undervaluation of companies. Many "Doesn't matter" advocates said making necessary adjustment was the responsibility of analysts. One "Other" supporter pointed out that 'certain transitional measures will be required as this will affect listing requirements'.