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4 September 2009

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

Dear Sir David:

re: Comments on Exposure Draft
"Financial Instruments: Classification and Measurement"

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on the exposure draft, "*Financial Instruments: Classification and Measurement*" put out by the International Accounting Standards Board (the Board). The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members exceed 23,000. The CAC is a standing committee of the SAAJ composed of 14 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 an ASBJ (the Accounting Standards Board of Japan) staff member as a lecturer. Some 172 certified members of the SAAJ participated in the session. A questionnaire was subsequently sent to session participants and 110 responded, making for a 64% 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 are attached as an Appendix to this letter.

Amortized Cost Method (Questions 1-3)

The exposure draft proposes reducing the classification categories of financial instruments from four to two (fair value and amortized cost). The CAC understands that this proposal is the Board's response to a request by the G20 to simplify accounting standards pertaining to financial instruments and thinks it has to basically accept it considering the situation in which the Board has been placed. As a result of the proposal, it is rational that a significant portion of securitized products, except for the most senior tranche, will be measured at fair value through profit or loss. For financial instruments valued at amortized cost, the CAC thinks that the fair values of these instruments also need to be disclosed in the notes. Some financial institutions invest a substantial portion of their assets in government and corporate bonds (many Japanese banks employ such a business model). The CAC is thus concerned that distinction between trading account and "managed on a contractual yield basis" account could be vague. Some members think more clarification is necessary as to what circumstances and to what degree sales of financial instruments are permitted in the latter account.

Fair Value Option (Questions 5-6)

The CAC agrees to retain the fair value option as it is a rational measurement to be applied to financial institutions whose income accrues from intentional mismatching between financial assets and liabilities.

Reclassification (Question 7)

The CAC basically supports the proposal in the exposure draft to prohibit reclassification. However, business models sometimes change fundamentally, for example, management changes associated with M&A. Under these circumstances, reclassification should be exceptionally permitted subject to (1) detailed disclosure of reasons for reclassification and its influence, and (2) no retrospective application.

Equity Instrument without a Quoted Price (Questions 8-9)

The CAC is against fair value measurement of equity instruments without a quoted price and whose fair value cannot be reliably measured, because fair value measurement of these instruments is technically difficult and likely to induce arbitrary valuation. The exposure draft implies fair value measurement of these instruments is not difficult as impairment is monitored "based on a calculation similar to fair value". However, downward measurement of impairment and upward measurement of fair value are technically very different. Impairment reflects valuation below book value, but does not deal with market value appreciation. Impairment is based on visible or more concrete evidence, but upward measurement takes account of invisible possibilities as well. For example, even when the same earnings per share are forecast, the fair value estimate could be significantly different according to what multiple (PER) is chosen. The maximum impairment loss is 100% of book value, while upward fair value has no limit. This nature of upward valuation tends to induce arbitrary use of valuation. Further, several entities may invest in the same company at the same time and at the same initial stock price (this often happens in investment in venture-type companies). These entities may measure the company's stock at significantly different prices based on the same principle of 'fair value'. Allowing this sort of unreliable valuation may erode the credibility of financial reporting.

Equity Instruments Measured at Fair Value through OCI (Questions 10-11)

(1) Fair Value through OCI

The CAC supports equity instruments elected by the management at initial recognition be measured at fair value through other comprehensive income (OCI). In Japan, there is a custom that a company holds other companies' shares long term for the sake of good business relationships. Measuring these investments at fair value through profit and loss would result in unnecessary volatility in net income as a performance indicator. This proposal seems to be made, bearing Japanese business customs in mind. The CAC applauds the Board's realistic proposal to take account of the business customs of non-EU countries.

(2) Recycling

The exposure draft proposes that sales gains or losses on the equity instruments mentioned above will not be recycled. The CAC opposes this. The fruits of a strategic investment will be included in net income as excess return. Stockholding is a cost to bring this excess return. Hence, when the holding ends, the sales gains or losses should be recognized in net income in order to fix the profitability of this investment. However, members' opinions were initially divided on whether these gains or losses are recycled or not. Some were against recycling because (1) the timing of sales can be arbitrarily decided to manipulate net income, and (2) realized gains or losses from assets held for the long term should not be included in net income which is a performance indicator for the current period.

About possible manipulation, the CAC is of the view that there are two kinds, 'tolerable' and 'intolerable'. When investors cannot recognize what was manipulated, then it is intolerable. On the other hand, when investors can easily recognize what was manipulated, then it is tolerable manipulation as it has information value for reading management's intention. We understand some Board members believe that recognizing sales gains in net income from a stock purchased 30 years previous in net income is meaningless. The CAC thinks that when a sale is clearly recognizable, it is meaningful enough to show the sales gains or losses in net income.

The exposure draft says "a gain or loss associated with these investments should be recognized once; therefore, recognizing a gain or loss in other comprehensive income and subsequently transferring it to profit or loss is inappropriate." (BC72) The CAC thinks information quality is quite different between ever changing OCI and realized gains or losses backed by cash. Realized gains or losses have information value. Once sold, the price will never change.

After the above deliberations, the CAC has agreed to permit recycling subject to recycled items and amounts being clearly shown in the income statement right above net income. Following is the format the CAC proposes:

Operating income	XXXX

Recycled during the period	
Equities	XXX
Foreign exchange	XX
Pensions	XX

Before tax net income	XXXX

(3) Dividends

The CAC opposes the exposure draft's proposal to recognize dividends from these investments in other comprehensive income (OCI). This would distort the current nature of OCI items which are related to unrealized gains and losses. Also, the proposal is inconsistent in that the opportunity cost of holding a stock (typically interest payment on the borrowing to purchase the stock) is recognized in net income while the dividend to offset the cost is included in OCI.

(4) Survey Results

The above opinion of the CAC takes into consideration the survey results mentioned earlier. Following is the most pertinent question and answer on the subject.

Q8: With recycling, the total amount of cash flow, net income, and comprehensive income would be exactly the same through the life of an entity. If gains or losses on sales are not recycled and dividends are recognized in OCI, as proposed in the exposure draft, then total net income will not be the same with the other two performance figures, and hence the current nature of reported net income composed of realized gains backed by cash and accruals would be significantly changed. What do you think about this?

A8:

Net income as it is reported today should be preserved.	72	65.4%
Accept the proposal.	29	26.4%
Cannot judge at this moment.	9	8.2%

<u>Alternative Approach (Questions 14-15)</u>

The CAC is against the alternative approach and its variations because they would not provide more decision-useful information than the original proposals.

If you have any questions or need further elaboration, please do not hesitate to contact Sei-Ichi Kaneko, Executive Vice President, SAAJ (s-kaneko@saa.or.jp).

Sincerely yours,

Keiko Kitamura

Keiko Kitamura
Chair
Corporate Accounting Committee

APPENDIX

Results of SAAJ Survey on 'Financial Instruments: Classification and Measurement'

Background and methodology

The Securities Analysts Association of Japan (SAAJ) sponsored a study session on IASB's exposure draft *Financial Instruments: Classification and Measurement,* inviting a lecturer from the Accounting Standards Board of Japan (ASBJ). Some 172 certified members of the SAAJ participated in the session held on 3 August. A questionnaire was subsequently sent to session participants and 110 responded, making for a 64% response ratio. The respondents could also add comments. The survey, although small in size, 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

Q1: IAS 39 has four financial instrument categories (trading, held for maturity, available for sale, and loans and receivables). The exposure draft, *Financial Instruments: Classification and Measurement,* proposes to reduce this to two (fair value and amortized cost). Do you think this simplification would enhance the decision usefulness of financial reporting?

A1:

Yes.	31	28.2%
No.	40	36.4%
Cannot judge at this moment.	39	35.4%

Q2: The exposure draft proposes that a financial instrument that (a) has only basic loan features, and (b) is managed on a contractual yield basis, should be measured at amortized cost. Do you think this approach would provide decision-useful information?

A2:

Yes.	14	12.7%
Yes, but market value of the instrument should be disclosed in the notes.	71	64.5%
No. All financial instruments should be valued at fair	17	15.5%

value.		
Cannot judge at this moment.	8	7.3%

Q3: The exposure draft retains the fair value option only when such designation eliminates or significantly reduces accounting mismatch. Do you agree that entities should continue to be permitted to use the option?

A3:

Yes, I think so.	58	52.7%
No, I don't think so.	13	11.8%
Cannot judge at this moment.	39	35.5%

Q4: IAS 39 and current Japanese standards permit reclassification of financial instruments under limited circumstances. On the other hand, the exposure draft prohibits reclassification. Do you agree with the prohibition?

A4:

Yes, arbitrary reclassification should be prohibited.	49	44.5%
No, business model changes will alter holding purposes and management methods. Reclassification should be permitted under these limited circumstances.	51	46.4%
Cannot judge at this moment.	10	9.1%

Q5: The exposure draft, unlike IAS 39 and the Japanese standards, proposes that equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured (such as non-listed stocks) should be measured at fair value, not at cost. Do you think fair value measurement of non-listed stocks, etc., would provide decision-useful information?

A5:

Yes.	36	32.7%
No.	46	41.8%
Cannot judge at this moment.	28	25.5%

Q6: The exposure draft proposes eliminating the available for sale category and to permit certain equity instruments elected by the management at initial recognition be valued at fair value through other comprehensive income (OCI). Some say this proposal takes account of the cross holding of stocks unique to Japanese companies. Do you agree with this proposal?

A6:

Agree.	61	55.4%
Disagree. At least, listed stocks should be measured at fair value through profit and loss.	30	27.3%
Cannot judge at this moment.	19	17.3%

Q7: With regard to equity instruments valued at fair value through OCI, the exposure draft, unlike IAS 39 and the Japanese standards, proposes (1) gains or losses on sales should not be recycled to net income, (2) dividend from such instruments should be recognized not in net income but in OCI, and (3) no impairments for such instruments. Do you think this approach would provide decision-useful information?

A7:

Yes.	36	32.7%
No.	48	43.7%
Cannot judge at this moment.	26	23.6%

Q8: With recycling, the total amount of cash flow, net income, and comprehensive income would be exactly the same through the life of an entity. If gains or losses on sales are not recycled and dividends are recognized in OCI, as proposed in the exposure draft, then total net income will not be the same with the other two performance figures, and hence the current nature of reported net income composed of realized gains backed by cash and accruals would be significantly changed. What do you think about this?

A8:

Net income as it is reported today should be preserved.	72	65.4%
Accept the proposal.	29	26.4%
Cannot judge at this moment.	9	8.2%