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30 November 2011

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Hoogervorst:

re: Comments on Request for Views on
"Agenda Consultation 2011"

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on Request for Views on "Agenda Consultation 2011" put out by the International Accounting Standards Board. The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members number 24,000. 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. The CAC writes comment letters to global standard setters, including the International Accounting Standards Board (IASB) and Accounting Standards Board of Japan (ASBJ), and exchanges opinions with organizations including the ASBJ and the Financial Services Agency. Following are our views on the questions raised in "Agenda Consultation 2011".

Question 1:

What do you think should be the IASB's strategic priorities, and how should it balance them over the next three years?

When the IASB was established in 2001, few expected that 10 years later IFRS would have been adopted by more than 100 countries. The CAC applauds the hard work of the IFRS Foundation and the IASB which brought about such wide acceptance of IFRS.

The rapid acceptance of IFRS, however, has caused some problems. First, as the IASB has had to concentrate on the standards selected in the MoU and also the financial instrument standards for which the G20 requested speedy amendments, the IASB has been unable to put enough resources into development of the conceptual framework project. Second, the same resource constraint prevented the IASB from conducting sufficient review of the implementation and application of the standards it developed. Third, under these circumstances, big influential projects including revenue recognition and leases are still to be introduced. The above considerations make the CAC believe that the coming few years should be a period in which to concentrate on the smooth implementation and application of the recently developed standards rather than to develop new ones.

From this perspective, the CAC thinks the following should be the priority areas for the IASB during the next few years: first, the conceptual framework, second, post implementation review, and third, limiting the development of new standards to just some urgently needed ones. A stable platform needed by many constituents would thus be provided by this prioritization.

<u>Question 1(a):</u>

Do you agree with the two categories we identified and the five strategic areas within them? If you disagree, how do you think the IASB should develop its agenda, and why?

The CAC agrees with the two categories but disagrees with one of the five strategic areas. The CAC believes that the resources IASB would be able to devote to “researching strategic issues for financial reporting” would be minimal given the three-year time span for agenda consultation and also the circumstances described in our response to Question 1 above. The CAC understands the importance of research activities for a standard setter in general, but the area of research should be limited to issues directly related to current standard developments. For the next three years, the CAC thus proposes excluding “researching strategic issues for financial reporting” from the five strategic areas.

<u>Question 1(b):</u>

How would you balance the two categories and five strategic areas? If you have identified other areas for the IASB’s agenda, please include these in your answer.

Amongst the four remaining strategic areas, the CAC thinks “conceptual framework” and “post implementation reviews” are most important.

Conceptual framework

In the conceptual framework, both a clear definition of income in Phase B of the project, “Definition of elements, recognition and derecognition”, and clarification of asset and liability measurement standards in Phase C, “Measurement”, are essential.

(a) Net income and recycling

Under the existing IASB conceptual framework, revenue and expenses are defined but net income is not. This is the root cause of repeated arbitrary decisions made by the IASB in regard to other comprehensive income (OCI) and its recycling. Defining revenue and expenses without the definition of income means implicit formulization of "revenue – expenses = income", which treats income only as residual. However, the formula is just an identity which does not suggest any causal relationship between the variables. Therefore, the right side of the equation (income) can define the left side (revenue and expenses). Mutual definition between the right and left sides of the formula yields a robust conceptual framework.

Some use the "asset – liability = equity" formula and regard the change in equity thus defined (excluding capital transactions) as income. The CAC thinks income thus defined (comprehensive income) is also useful for investment decision making. The conceptual framework should clearly define both of the two income concepts.

The CAC has consistently opined that all OCI items should be recycled[1] for the following reasons. First, while accumulated other comprehensive income (AOCI) numbers fluctuate every year because of changes in the markets, realized value is fixed. Once realized, the fixed number has informational hardness which makes recognition in net income worthwhile. Second, by recycling all AOCI items, total cash flow, net income, and comprehensive income for the life of a corporation will be exactly the same. This means that the balance sheet, income statement, and cash flow statement are connected by three bridges. The connection enhances the cohesiveness of financial statements. Third, when a clean surplus relationship is established between net income and changes in sum of capital and retained earnings, net income can be used as an input to the residual income model.[2] Fourth, when some items in AOCI are not recycled, retained earnings may include realized and unrealized gains. The CAC thinks retained earnings should be composed of only realized gains that belong to stockholders. Fifth, the definition of net income by the realization concept mentioned above has a clear advantage of showing two different incomes on the income statement; namely, comprehensive income that includes valuation gains/losses and net income that includes solely realized gains and losses. Finally, full

[1] A few CAC members think OCI occasioned by the cross holding of shares should not be recycled because it could be used to manipulate net income. Others think that the recycling of cross holding shares has information value when recycling is clearly shown on financial statements.

[2] Three types of stock price valuation models are commonly used: the dividend discount model, the cash flow discount model, and the residual income model. The dividend discount model is difficult to apply to companies that do not pay dividends, and the cash flow discount model is difficult to apply to growing companies whose cash flows are negative. The residual income model is free from these restrictions but the model assumes a clean surplus relationship.

recycling will resolve one of the major differences between IFRS and US GAAP and Japanese GAAP and prevent mutation of the traditionally important meaning of net income.

The debate about net income and recycling is caused by modern accounting standards which are seeking an optimal solution between pure acquisition cost accounting based on revenue and expense views, and pure fair value accounting based on asset and liability views. The CAC thinks Japanese GAAP is a model which synthesizes the two views by showing fully recycled net income and comprehensive income and dividing the capital (called net assets) into stockholders' equity and 'other' (AOCI, stock options and minority interests).[3] Clean surplus relationships exist between net income and stockholders' equity and between comprehensive income and net assets.

A thorough conceptual consideration of net income and recycling which relates to the basis of modern accounting standards is essential for making IFRS a robust set of accounting standards. However, some speculate that if the issue is considered in Phase B of the project, it would take at least 10 years for completion. Therefore, the CAC proposes expediting the project by limiting the scope to net income and recycling.

(b) Measurement

With regard to asset and liability measurement, the CAC has opined that incorporation of management intent will make information in financial statements rich and meaningful. It has also opined that the financial liabilities of non-financial companies are typically used to acquire assets needed for business and it is therefore opposed to the fair value measurement of these liabilities. Some stakeholders in Japan still believe that the IASB's ultimate goal is to measure all assets and liabilities at fair value. In order to eradicate these biased views, clear measurement standards should be established in Phase C of the project.

Post implementation reviews

The IASB's policy is to conduct post implementation review two years after standards become effective. The CAC proposes expanding the scope of post implementation review to include standards developed more than two years previous and also guidance developed

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[3] For a description of the basic philosophy behind Japanese GAAP, see the following, particularly Chapter 3: The Accounting Standards of Japan, *The Discussion Paper "Conceptual Framework of Financial Accounting"*, 2006.
https://www.asb.or.jp/asb/asb_e/asbj/begriff/ConceptualFramework200612.pdf
The following article is useful as an analysis of Japanese accounting standards from historical, political, and economic perspectives: Tsunogaya. N., H. Okada, and C. Patel, "The Case for Economic and Accounting Dualism: Towards Reconciling the Japanese Accounting System with the Global Trend of Fair Value Accounting", *Accounting, Economics, and Law,* Vol 1, Issue 2, 2011. Available from
http://www.bepress.com/ael/vol1/iss2/5

by IFRIC. Post implementation reviews are scorecards for the standard setter. By expanding the scope of scorecards, the ISAB can more precisely evaluate its performance during the past 10 years and this evaluation will be precious input for the future development of standards. Post implementation review in regard to capitalization of development costs and recapturing impairment of fixed assets, which are major differences between IFRS and US GAAP and Japanese GAAP, will provide valuable input for the convergence of the three standards.

<u>Question 2:</u>

What do you see as the most pressing financial reporting needs for standard-setting action from the IASB?

As stated in our response to Question 1, the CAC thinks the most pressing needs focus on i) the conceptual framework project to clarify the concept of income, and ii) post-implementation review, including of standards developed in the past. In fact, the CAC thinks the need for these two projects is higher than for the four ongoing projects and proposes prioritizing them.

<u>Question 2(a):</u>

Considering the various constraints, to which projects should the IASB give priority, and why? Where possible, please explain whether you think that a comprehensive project is needed or whether a narrow, targeted improvement would suffice?

Amongst the four projects the IASB is working on now, the CAC thinks financial instruments has the highest priority. It might be difficult to build a consensus among stakeholders when turbulence in financial markets is continuing and there still remains a huge gap between IFRS and US GAAP. However, once this difficult task is achieved, the IASB can allocate substantial resources to other projects.

Among the five activities and projects the IASB is already committed to or is required to do so, the CAC's priority is on the conceptual framework and post implementation review as mentioned above. On the other hand, the CAC thinks 'undertaking three-yearly review of the IFRS for SMEs' has relatively low priority. The CAC understands that SMEs were developed to offer a stable IFRS platform for small to medium-sized entities, and, if so, regular review is not so pressing. As shown in CAC's response to Question 1(a), it proposes excluding 'researching strategic issues for financial reporting' from the five strategic areas. By the same token, the CAC thinks 'investing in research in preparation for future standard-setting needs' should be limited to the minimum.

Question 2(b):

Adding new projects to the IASB's agenda will require the balancing of agenda priorities with the resources available.

Which of the projects previously added to the IASB's agenda but deferred (see table page 14) would you remove from the agenda in order to make room for new projects, and why? Which of the projects previously added to the IASB's agenda but deferred do you think should be reactivated, and why?

Please link your answer to your answer to question 2(a).

Amongst the 10 projects added to the agenda but deferred, the CAC thinks 'other comprehensive income' has the highest priority. In the answer to Question 1(b), the CAC proposes expediting the project by limiting the scope to net income and recycling. The 'other comprehensive income' project is closely correlated with net income and recycling. Hence, the project should be considered in the context of the conceptual framework. Further, presentation of recycled gains/losses should be considered in the context of 'financial statement presentation'.

Among the 16 newly proposed projects, the CAC thinks 'intangible assets' has the highest priority. The project's scope includes whether goodwill should be depreciated or not and whether capitalization of development expenses should be permitted or not. *Agenda Consultation 2011* mentions "There are many who consider the current standard, IAS 38 *Intangible Assets*, as out of date and not appropriately reflecting economic conditions or results" (page 24). The CAC recommends performing a post implementation review of IAS 38 and reviewing guidance appropriateness to judge the capitalization of development expenses. The CAC proposes including 'intangible assets' on the agenda and deliberating development cost and depreciation (or not) of goodwill.

The CAC also thinks that 'discount rate' should be included on the agenda. The discount rate used to obtain present value is very important in corporate analysis and valuation. Only a small change in the rate results in a huge difference in valuation. Although IFRS depend heavily on the use of discounted present value in measuring assets and liabilities, there are differences in the definition of the discount rate among current standards. This makes corporate analysis difficult and represents a lack of consistency in IFRS. Further, the recent significant surge in some or rather many European countries' government bonds yields offers a new challenge of how to define the risk free rate. *Agenda Consultation 2011* writes "A future project could aim to provide more consistent guidance on how to determine discount rates" (page 21). The CAC thinks this project should be front-loaded as an urgent issue.

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