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

Dear Mr. Hoogervorst:

re: Comments on Discussion Paper
"A Review of the Conceptual Framework for Financial Reporting"

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on Discussion Paper "A Review of the Conceptual Framework for Financial Reporting" (hereinafter referred to as the DP) put out by the International Accounting Standards Board (IASB). The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members number 25,000. The CAC is a standing committee of the SAAJ composed of 15 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 IASB and Accounting Standards Board of Japan (ASBJ), and exchanges opinions with organizations including the ASBJ and Financial Services Agency.

Before drafting this comment letter, the SAAJ sponsored a study session on the DP, inviting an ASBJ member and a staff as lecturers. Some 75 of our certified members participated. A questionnaire was subsequently sent to each and 35 responded, making for a 47% response rate. This comment letter fully takes into account the views expressed in the questionnaire replies as well as discussion among CAC members. The survey results are attached as an Appendix.

General Comments

1. The CAC highly regards the IASB's work on the conceptual framework project reflecting the opinions of constituents regarding Agenda Consultation. The conceptual framework is an indispensable basis for users to understand financial

statements and completion of the project is a necessary step for global adoption of the IFRS as a robust set of accounting standards.

2. Many proposals in the DP, including acceptance of the mixed attribute measurement model and presentation of net income (hereinafter net income is used as an equivalent to "profit or loss"), reflect the voice of constituents and are much more realistic than the deliberations of the IASB up until only a few years ago. The CAC praises the IASB for this. On the other hand, the CAC thinks net income should be defined as an element of financial statements and widely defined other comprehensive income (hereinafter OCI) items should be fully recycled. Following are our comments on selected questions.

<u>Question 1</u>

Paragraphs 1.25–1.33 set out the proposed purpose and status of the Conceptual Framework. The IASB's preliminary views are that:

(a) the primary purpose of the revised Conceptual Framework is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and

(b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the Conceptual Framework. If this happens the IASB would describe the departure from the Conceptual Framework, and the reasons for that departure, in the Basis for Conclusions on that Standard.

Do you agree with these preliminary views? Why or why not?

3. The DP defines the primary purpose of the revised Conceptual Framework as "to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRS" (paragraph 1.26). The CAC regards this definition as being too narrow. The first chapter of a typical IFRS textbook begins with an explanation of the Conceptual Framework. This symbolizes the fact that the Conceptual Framework is a base document referred to by all the relevant constituents in producing and interpreting IFRS-based financial statements. In this regard, the Conceptual Framework is expected to function as a de facto constitution and behavioral guidance code. Putting a higher priority on the IASB than other constituents including preparers and users will restrict broad usage of the Conceptual Framework described above. The purpose, therefore, should include a wide range of constituents as in the

existing Framework.

4. In regard to Question 1(b), the CAC recognizes the possibility that a future standard may come to be in conflict with the Conceptual Framework. In such a case, the CAC thinks revision of the Conceptual Framework should be considered in addition to an explanation for such departure in Basis for Conclusions of the Standard.

<u>Question 4</u>

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37–2.52. Do you have any comments on these items? Would it be helpful for the *Conceptual Framework* to identify them as elements of financial statements?

5. Paragraph 2.39 of the DP stipulates "Profit or loss, total OCI and total comprehensive income are not elements of financial statements." It is obvious that a formula of "Income – Expense = Net Income (or Profit or Loss)" shows net income as a residual. This formula is only an identity equation which does not explain any causal relationship. To identify net income (profit or loss) as an element of financial statements and to define it might influence the definition of income and expense. By going through this process, however, financial statements will become truly robust. Albeit it is a challenging task, the definition of net income should not be avoided.

6. Net income is quite an important performance measure of the accounting period, representing the amount belonging to the owners of an entity after paying all expenses including taxes. The Accounting Standards Board of Japan has been developing the definition of net income. The CAC respectfully asks the IASB to participate in this development process with other relevant bodies.

7. OCI is a periodic net change in Accumulated Other Comprehensive Income (hereinafter AOCI) on the balance sheet. In the past, OCI was not disclosed in financial statements. However, it was decided rather recently to show OCI on the income statement to reflect changes in the balance sheet. As this history clearly shows, OCI is essentially a linkage item between the balance sheet and income statement. In this sense, the nomenclature of Other Comprehensive *<u>Income</u>* is

misleading and it should be renamed, for example, to Miscellaneous Valuation Changes (this comment letter will continue to use conventional OCI and AOCI). The importance of OCI is widely different according to respective companies and industries. An entity that has a huge amount of share crossholdings and foreign currency exposure (including at many foreign subsidiaries) may exhibit volatile OCI because of changes in the stock and foreign exchange markets. OCI reflects changes in the financial stability of the entity and it may be realized and recycled to net income in due course of time. OCI, nonetheless, is neither net income nor income in the ordinary sense of accounting. The importance of OCI is also different according to business model. For example, OCI of a financial institution is generally more important than that of a manufacturing company because, in the financial business, asset and liability mismatches and different valuation methods applied to assets and liabilities cause unavoidable timing differences to be reflected in OCI.

8. In our survey, 63% said net income should be clearly defined as an element of financial statements (see Q2 in the Appendix).

Question 10 (**a)**

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB's preliminary view:

(a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

9. The Conceptual Framework should require clear and separate listing of retained earnings and AOCI in the equity section of the balance sheet.

10. The DP explains the rationale of not requiring separate listing as "determining which categories are most relevant to users of financial statements may depend on local legislation and on the reporting entity's governing constitution" (paragraph 5.5). The CAC is well aware that local legislation may require various provisions and/or reserves in the equity section. Further, the explanation cited above is consistent with the view which denies net income and, as a result, prohibits recycling. The DP, on the other hand, confirms the continued presentation of net

income (paragraph 8.22) and suggests acceptance of recycling albeit with a possibly limited scope (paragraph 8.97).

11. When net income is shown with recycling, retained earnings and AOCI, which have quite a different nature, need to be distinctly separated. Retained earnings show a fixed amount that is not subject to changes from future valuation. In many jurisdictions, it is also the maximum amount payable as dividends. On the other hand, AOCI is only a tentatively valued amount on the balance sheet date that is subject to substantial changes in the future. As hardness and usage of information is so different between retained earnings and AOCI, they need to be shown separately. The separation is particularly relevant and material in analyzing companies with substantial and volatile AOCI, like some Japanese companies with a huge amount of share crossholdings and foreign currency exposure (including at many foreign subsidiaries). For example, let's assume an entity with 100 CU retained earnings and 0 CU AOCI (i.e. no exposure to OCI items) and another entity with 200 CU retained earnings and △100 CU AOCI (i.e. huge exposure to OCI items). Both entities' total retained earnings and AOCI are the same with 100 CU. The latter entity's total amount, however, is subject to changes occasioned by movements in the stock and foreign exchange markets making the former entity's financial stability much better than that of the latter. The separate listing of retained earnings and AOCI will enable such analysis.

12. The CAC regards one major defect of current IFRS is not requiring separation of retained earnings and AOCI. As explained later (paragraph 19), the separation is necessary as the transfer from AOCI to retained earnings will provide relevant information to financial statement users.

<u>Question 11</u>

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35. The IASB's preliminary views are that:

(a) the objective of measurement is to contribute to the faithful representation of relevant information about:

(i) the resources of the entity, claims against the entity and changes in resources and claims; and

(ii) how efficiently and effectively the entity's management and governing

board have discharged their responsibilities to use the entity's resources.

(b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;

(c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;

(d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:

(i) for a particular asset should depend on how that asset contributes to future cash flows; and

(ii) for a particular liability should depend on how the entity will settle or fulfil that liability.

(e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and

(f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

13. The CAC basically agrees with the IASB's preliminary views on measurement as summarized in Question 11 above. Users obtain two different kinds of information from financial statements. Firstly, information regarding an entity's periodic performance is obtained primarily from the income statement to be used to forecast future cash flows. Secondly, information regarding an entity's financial stability is obtained mainly from the balance sheet. Historical cost measurement is well suited when applying the matching principle to measure periodic performance, and current cost measurement is well suited when applying fair valuation of certain assets and liabilities to evaluate financial stability. Intrinsic value of an entity is calculated by the present value of future cash flows estimated from periodic performance numbers. Financial stability of the entity will be reflected in the risk premium which is part of the discount rate. Some analysts also make provisional valuation using a current

value-based balance sheet. More than one measurement basis is required as users need two different kinds of information: periodic performance as ‘flow information’ and financial stability as ‘stock information’.

14. Question 11(e) stipulates “the numbers of different measurements used should be the smallest number necessary”. The CAC thinks that when a standard is developed relevantly, the number of measurements used should be optimal and making “the smallest necessary number” as a target may bring biases into the standard development process. The CAC respectfully proposes to delete the word “smallest”.

<u>Question 17</u>

Paragraph 7.45 describes the IASB’s preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.
Do you agree with this approach? Why or why not?

15. The DP stipulates that “the concept of materiality is clearly described in the existing *Conceptual Framework*” (paragraph 7.45). Even if the concept is clearly described, it is not effectively working in current financial reporting practices. As the threshold of materiality is not clear, many preparers produce a massive amount of boilerplate information as precautionary measures. When the IASB publishes a discussion paper or exposure draft relating to a new standard, some preparers vigorously oppose it because of the fear they will have to produce additional information that is not material. Practical and effective use of the materiality concept is inevitable for the IFRSs to function as high quality accounting standards. The CAC agrees with the DP on the assumption that the IASB recognizes the problem explained above and that it proposes the development of additional guidance or educational material rather than revision of the Conceptual Framework as the best solution.

16. Guidance and education material easily remind one of quantitative thresholds. For users, however, qualitative application of materiality is equally important. Qualitative materiality will only be established through the best practices of constituents, including preparers, auditors, users, and regulators. Guidance and educational material should be developed through this process.

17. In our survey, 63% of the respondents supported the development of additional guidance and education material.

<u>Question 19</u>

The IASB's preliminary view that the *Conceptual Framework* should require a total or subtotal for profit or loss is discussed in paragraphs 8.19–8.22.
Do you agree? Why or why not?
If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or revising particular Standards?

18. As explained in paragraphs 9-12 above, the CAC thinks net income should be defined as an element of financial statements. From this position, it is natural and obvious to require net income to be disclosed in financial statements. Net income is required because it has unique bottom line characteristics as the profit that has been realized in the period and that belongs to shareholders. Investors use several indicators to analyze periodic performance of an entity. Operating income, EBIT or EBITDA are important as indicators of recurring cash flow that are not influenced by capital structure or effective tax rates of the entity. In contrast, net income is important as the bottom line profit left to shareholders, after payment of interest and taxes, to be the source of future dividends. Earnings per share (EPS), obtained by dividing net income by the number of outstanding shares, is also an important indicator which is used to calculate PER (price to earnings ratio), a measure widely used to judge the level of stock prices. As net income is such an established number, it should be clearly defined in the Conceptual Framework as an element to enforce comparable disclosure.

<u>Question 20</u>

The IASB's preliminary view that the *Conceptual Framework* should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, ie recycled, is discussed in paragraphs 8.23–8.26.
Do you agree? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not?
If you do not agree, how would you address cash flow hedge accounting?

19. The CAC thinks all valuation gains and losses recorded as OCI should be recycled to net income when certain trigger events occur. As the value of an OCI item fluctuates depending on changes in relevant markets, when the item is derecognized and value fluctuation ends, the realized amount should be recognized in net income and the corresponding amount in AOCI should be transferred to retained earnings. As explained in paragraphs 9-12 of this comment letter, the CAC thinks clear distinction of retained earnings and AOCI will make for relevant financial reporting.

20. If not all OCI items are recycled, accumulated net income will not equal to retained earnings excluding capital transactions. This will make net income vulnerable. As net income is widely used, full recycling is necessary to make it a robust indicator.

21. Some who opine prohibiting recycling assert that income once recognized as OCI should not be recognized twice as net income after recycling. As the CAC pointed out in paragraph 7 of this comment letter, an entry in OCI is not recognition of income but simply a result of revaluation of certain assets and liabilities to check the financial stability of an entity. As the OCI entry is not income recognition in the first place, it is inappropriate to call the recycling as second income recognition. Some also opine that the recycled amount may not meet the definition of income and expense. As explained in paragraphs 9-12, however, the transfer from AOCI to retained earnings as a result of recycling is relevant information and the corresponding amount should be recognized as income or expense for the period.

22. How to find a trigger event for recycling is a practical issue. For example, actuarial differences in post employment benefits are not recycled under current standards because of lack of an appropriate trigger event. The CAC thinks trigger events can be developed through serious deliberation and using the lack of such events as the reason for non-recycling is simply evidence of dereliction as a standard setter.

23. Another reason for opposing recycling is susceptibility to earnings management. The CAC does not deny this aspect, especially when one focuses only on net income. The disclosure of comprehensive income and note disclosure of recycled amount, the CAC thinks, have substantially reduced potential confusion on the part of investors regarding earnings management and simultaneously have reduced the incentive of entities to engage in such management. In order to further reduce such incentive, the

CAC proposes requiring disclosure of the current period recycled amount as a breakdown of net income.

24. Some oppose recycling because it may increase the volatility of net income. This is a view that seeks a recurring nature in net income. The CAC thinks recurring income is better measured by operating income or EBITDA. As net income is located in between operating income/EBITDA and comprehensive income, it is desirable from the perspective of corporate analysis to give net income distinctive characteristics. As operating income/EBITDA shows recurring performance of an entity independent of the capital structure and comprehensive income shows net changes in owners' equity reflecting valuation gains and losses of certain assets and liabilities, net income that lies in between these indicators should have the characteristics as bottom line income that is realized in the period to belong to the shareholders. The advantage of such distinctive characteristics far outweighs the disadvantage of volatility.

25 Operating income (or EBIT/EBITDA) is also widely used as a starting point of corporate analysis. In order to enhance benefits for users and comparability, sufficient information to calculate these indicators should be provided on the income statement, at least as a note.

26. In our survey, 77% of the respondents supported recycling (see Question 3 in the Appendix).

Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40–8.78) and a broad approach (Approach 2B described in paragraphs 8.79–8.94). Which of these approaches do you support, and why?
If you support a different approach, please describe that approach and explain why you believe it is preferable to the approaches described in this Discussion Paper.

27. To the extent necessary to evaluate financial stability of an entity, the CAC thinks broad items should be included in OCI and, as explained above, all OCI items should be recycled. The CAC hereby proposes the third approach (a broader approach requiring all OCI items to be recycled).

28. The difference between Approach 2A and 2B in the DP is that the latter includes a “transitory remeasurements” category where recycling or non-recycling will be determined case by case. The CAC thinks there is no essential difference between “transitory remeasurements” and “bridging item” except that duration could be longer and indefinite in the former. If “transitory remeasurements” were integrated into “bridging item”, then all existing OCI items would be recycled, in line with our opinion.

29. In our survey, 34% supported the third approach with 2A and 2B supported by 14% and 20% respectively. The remaining 31% answered “cannot decide at this moment” (see Q4 in the Appendix). A predominant majority of CAC members supported the third approach.
One member who supports 2B opines the possibility of earnings management is a problem and that although OCI items have been fully recycled in Japan, market participants still do not fully understand recycling which causes biases in stock prices. For example, in the case of share crossholdings, the stock price tends to decline twice: first when the loss is recognized in OCI and second when the loss is realized and recycled to net income. On the other hand, when valuation gains are recognized in OCI, the stock price would barely respond to the news and even when it is realized and recycled to net income, the stock price tends to disregard it as non-core profit. The member cites this asymmetry as the reason for supporting 2B.

<u>Question 22</u>

***Chapters 1 and 3 of the existing* Conceptual Framework**

Paragraphs 9.2–9.22 address the chapters of the existing *Conceptual Framework* that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters.

Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the *Conceptual Framework*.

30. There is a strong voice requiring the resurrection of the concepts of stewardship, reliability, and prudence with which the CAC empathizes. Stewardship is said to have been removed because it is difficult to translate, but which difficulty is not a conceptual reason for removal. Prudence is said to have been removed because it conflicts with neutrality. Even the DP admits, however, that management has a natural bias towards optimism while investors are more concerned about downside risks than upside potential (paragraph 2.28). For example, a stock price decline occasioned by impairment of an asset would be much larger than a stock price hike occasioned by a reversal of bad debt reserves, causing undesirable volatility in the market. Assuming this, slightly conservative accounting may bring about desired neutrality for the markets. In this regard, the concept of prudence should also be resurrected. As to reliability, some prefer the current concept of “faithful representation” to “reliability” because the former is more specific and desirable.

31. As mentioned in paragraph 3, the Conceptual Framework is behavioral guidance for many constituents. The basic concepts of stewardship, reliability, and prudence are particularly important as behavioral guidance. The resurrection of these concepts can be made without fundamental reconsideration of chapters 1 and 3 of the existing Conceptual Framework and resurrection would not have a major impact on other concepts currently under deliberation.

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 "Conceptual Framework"

Background and methodology

The Securities Analysts Association of Japan (SAAJ) sponsored a study session on IASB's discussion paper "A review of the Conceptual Framework for Financial Reporting", inviting lecturers from the Accounting Standards Board of Japan (ASBJ). Some 75 of our certified members participated in the session held on 12 November. A questionnaire was subsequently sent to each participant and 35 responded, making for a 47% response rate. The respondents were also invited to make 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: Materiality

The IASB does not propose to amend the existing Conceptual Framework in regard to the concept of materiality but instead proposes to provide additional material on the application of materiality by amending IFRSs or by providing educational material.

What do you think about the IASB's proposal?

A1

(a) Additional guidance and educational material will suffice.	62.8%
(b) Should amend the Conceptual Framework.	22.9%
(c) Cannot judge at this moment.	14.3%
Total	100.0%

Q2: Net Income

The IASB's preliminary view is not to include net income in elements of financial statements but to retain and present net income as a total or a sub-total in the statement of profit and loss and other comprehensive income.

What is your opinion about the preliminary view?

A2

(a) Agree with the preliminary view.	28.6%
(b) Net income should be included in the elements of financial statements and be clearly defined.	62.8%
(c) Cannot judge at this moment.	8.6%
Total	100.0%

Q3: Recycling

The IASB's preliminary view is that the Conceptual Framework should permit or at least require some income and expense items previously recognized in OCI to be subsequently recognized in profit or loss, i.e. recycled.

What is your opinion about the preliminary view?

A3

(a) Agree with the preliminary view.	77.2%
(b) Disagree with the preliminary view. Recycling is not necessary.	5.7 %
(c) Cannot judge at this moment.	17.1%
Total	100.0%

Q4: Recycling Approaches

The IASB proposes two approaches for recycling:

(a) a narrow approach requiring all two-category OCI items to be recycled (Approach 2A),

(b) a broad approach requiring qualified three-category OCI items to be recycled (Approach 2B).

In addition, a third approach (a broader approach requiring all OCI items to be recycled, Approach 2C) is possibly explored.

What approach do you think is most appropriate?

A4

(a) Narrow approach (2A)	14.3%
(b) Broad approach (2B)	20.0%
(c) Broader approach (2C)	34.3%
(d) Cannot judge at this moment.	31.4%
Total	100.0%