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

Re: Comments on Exposure Draft
"Conceptual Framework for Financial Reporting"

Dear Mr. Hoogervorst:

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on Exposure Draft "Conceptual Framework for Financial Reporting" (hereinafter referred to as the ED) 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 26,000. 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 accounting 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 ED, inviting an ASBJ member and a senior staff as lecturers. 65 of our certified members participated. A questionnaire was subsequently sent to each and 35 responded, making for a 54% 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. We commend the IASB's well-organized descriptions of individual concepts, despite not being enough, reflecting various opinions of constituents regarding Discussion Paper "A Review of the Conceptual Framework for Financial Reporting" (hereinafter referred to as the DP) published in July 2013 by the International Accounting Standards Board (IASB). However, we are really disappointed at the IASB's reluctance to define the most important element, net income (hereinafter net income is used as an equivalent to "profit or loss") in Exposure Draft "Conceptual Framework for Financial Reporting" (hereinafter referred to as the DP).

2. What does the most important element net income for users of financial statements mean? No definition of that is a major defect in the Conceptual Framework. The IASB seems to hesitate to take a step forward from the equation "Net Income (or Profit or Loss) = Income – Expense" and to define net income. However, we strongly believe that the definition of net income articulated by the IASB will be extremely useful and important for the users of financial statements to understand financial statements and thus is an essential element for the Board to improve the quality of the Conceptual Framework.

Question 1—Proposed changes to Chapters 1 and 2

Do you support the proposals:

(a) to give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources;

3. We support the IASB's revisions to give more prominence to the importance of management's stewardship of the entity's resources, as the importance of information regarding management's stewardship in financial reporting is increasing year by year.

Question 1—Proposed changes to Chapters 1 and 2

Do you support the proposals:

(b) to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty) and to state

that prudence is important in achieving neutrality;

4. We support the IASB's proposal to reintroduce an explicit reference to the notion of prudence in paragraph 2.18 of the Conceptual Framework. In the point of view of users, it is desirable for financial statements to faithfully represent the economic substance of an entity based on prudent, instead of optimistic, judgements, under conditions of uncertainty. As accounting treatments based upon future estimates including impairment tests and deferred tax assets have increased, we think it is significant to reintroduce prudence as the exercise of caution.

5. In our survey, 83% of the respondents supported the reintroduction of prudence to the Conceptual Framework (see Q1 in the Appendix).

Question 1—Proposed changes to Chapters 1 and 2

Do you support the proposals:

(e) to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?

6. It seems that relevance which represents a qualitative characteristic of useful financial information partially depends on various users' subjectivity, and the word "relevance" by itself may lack stability as a judgement criterion. Some constituents opined when using relevance as a judgment criterion in the Conceptual Framework, it would be necessary to consider deliberately its meaning in the light of the objective of financial reporting.

Question 6—Recognition criteria

Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why?

7. We have divided opinions on the IASB's proposals that the probability criterion "any future economic benefit associated with the item will flow to or from the entity" is deleted and an entity recognizes an asset or a liability if paragraph 5.9(a)-(c) of the Conceptual Framework are provided to users. In our survey, 37% of the respondents supported the proposed approach, 37% didn't support, and the remaining 26% answered that they "could not decide at this moment" (see Q2 in

the Appendix). Neither answer gathered a majority.

8. Many of the respondents who supported the proposal highly evaluated that it in respect of consistent recognition of some derivatives such as deep out-of-the-money options as a result of deletion of a probability criterion from the Conceptual Framework. Meanwhile, others are concerned that necessary disclosures to users might be no more provided because paragraph 5.9(a)-(c) are not quantifiable criteria and the decision to recognize them on the balance sheet are fully left to the preparers' subjective judgment. They tend to answer "do not support", or "cannot decide at this moment". Deleting a probability criterion to solve the recognition issues of derivatives could create other major problems in future. We think the derivative issues should be addressed not in the Conceptual Framework but by developing individual standards.

9. "Relevant information" (paragraph 5.9(a)) and "a faithful representation" (paragraph 5.9(b)) depict only the fundamental qualitative characteristics of useful financial information. Such ambiguous criteria alone have a great risk to undermine stability and reliability of entire financial statements. We think either of a probability criterion or a set of paragraph 5.9(a) and (b) alone is not enough as recognition criteria. We encourage the IASB to examine advantages and disadvantages of both and revise the paragraph based on the intention of 5.9(a) and (b) and the proposed new recognition criteria to include a probability criterion to be remain intact instead of simple replacement of them.

10. We believe that the threshold of "probable" or "more likely than not" would work well in many cases as the probability criteria for recognition. In the rare cases, however, where these criteria do not work, some of our members suggest to add such a sentence to the paragraph 5.9 as "the Board should explore the other threshold optimal to each individual standard based upon the relevance and faithful representation in accordance with the objective of that standard."

11. Because of the paragraph 5.9(c) "information that results in benefits exceeding the cost of providing that information (see paragraph 5.24)", we are also seriously concerned that paragraph would discourage preparers to provide appropriate information because they have very different perceptions on benefits from users. We believe that the costs and benefits of providing information are not specific to the recognition criteria and should be discussed by developing individual disclosure and other standards rather than in the Conceptual Framework. We propose the IASB

that paragraph 5.9(c), 5.24 and similar description 4.62(c) be fully deleted from the Conceptual Framework.

<u>Question 8—Measurement bases</u>

Has the IASB:

(a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?

12. We agree the IASB's proposals that measurement bases are categorized as (a) historical cost or (b) current value in paragraph 6.4 of the Conceptual Framework and current value measurement bases include (a) fair value and (b) value in use for assets and fulfilment value for liabilities in paragraph 6.20. In our survey, 80% of the respondents think the categorization correctly identifies the measurement bases, and that there would be no problem in the four categories of historical cost, fair value, value in use, and fulfillment value (see Q3 in the Appendix).

13. Having said that, we are not comfortable at all with the paragraph 6.24 which says "fair value for a liability includes own credit risk" and the paragraph 6.36 which says "fulfillment value for a liability includes a risk premium". We are concerned that these paragraphs should imply that liabilities could include those that will be not realized as cash flows if it is measured by current value. We propose to fully delete paragraph 6.24 and 6.36. We also propose that the IASB should consider the measurement bases for a liability carefully in an independent project separated from the Conceptual Framework.

14. We strongly believe that paragraphs 6.25 and 6.30 are inconsistent with the objective of the general purpose financial statements. The paragraph 6.25 says "However, users may sometimes find it counterintuitive to recognize an initial expense including the risk premium, and then subsequently to recognize the same amount as income" while the paragraph 6.30 says "However, depending on the item that is being measured and the nature of the business activities conducted by the entity, users may not always find information about estimates of changes in expectations of market participants relevant". We are concerned that these paragraphs conflict with the objective of general purpose financial reporting in paragraph 1.2 and are inappropriate for the Conceptual Framework by nature. We

propose the IASB to fully delete paragraph 6.25 and 6.30 if the Board cannot express the intention of its proposals without such descriptions inconsistent with the higher level objectives.

<u>Question 9—Factors to consider when selecting a measurement basis</u>

Has the IASB correctly identified the factors to consider when selecting a measurement basis? If not, what factors would you consider and why?

15. We regard the paragraphs 6.23 and 6.54 generally appropriate as the factors to consider when selecting a measurement basis, which include;

- the information that measurement basis will produce in both the statement of financial position and the statement(s) of financial performance(paragraph 6.53)
- the way that asset or liability contributes to future cash flows(paragraph 6.54(a))
- the characteristics of the asset or the liability (paragraph 6.54(b)).

In our survey, 61% of the respondents supported the proposals in the ED (see Q4 in the Appendix).

16. However, we are concerned that the descriptions in paragraph 6.54 are too ambiguous to prevent preparers from selecting a measurement basis arbitrarily. For example, paragraph 6.54(a) says, “This will depend in part on the nature of the business activities conducted by the entity.” We believe “in part” should be removed from the sentence above to eliminate ambiguity as much as possible. In addition, we are concerned just one case of a property is not sufficient for preparers to select the relevant measurement basis, whether historical cost or current value, leaving a much room for diversity in practice. Furthermore, we find “the characteristics of the asset or the liability” in paragraph 6.54(b) too abstract as the factors to be considered when a preparer selects a measurement basis. As the case mentioned above, we are concerned that there seems a great risk of diversity in practice to select a measurement basis.

<u>Question 12—Description of the statement of profit or loss</u>

Do you support the proposed description of the statement of profit or loss? Why or

why not? If you think that the Conceptual Framework should provide a definition of profit or loss, please explain why it is necessary and provide your suggestion for that definition.

<u>Question 3—Definitions of elements</u>

Do you agree with the proposed definitions of elements?

17. We agree with paragraphs 7.19 through 7.21 in the ED. In our survey, 66% of the respondents also agreed with the IASB's proposals (see Q6 in the Appendix).

18. In particular, we believe it is consistent with users' intuition for the ED to articulate that income and expenses included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period. We appreciate the IASB for including this important articulation in the ED. All the more, however, we are disappointed to find no definition of net income in the Conceptual Framework. In our survey, the majority of the respondents did not agree with the ED's proposals, or said they could not judge at this moment because there was no definition of net income in the ED.

19. We expressed the following opinions on net income in the comment letter to the DP published in July 2013 and we have been maintaining this view since then;

    "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."

20. Hence, we do not agree with the IASB's proposals not to define "net income" as an element in Chapter 3. Our survey also suggests that 54% of the respondents think net income and other comprehensive income (in particular the former should be

defined as the elements of financial statements (see Q7 in the Appendix).

21. We believe that if net income is defined in the Conceptual Framework, the IASB's proposals such as the statement of profit or loss and the use of OCI will be clearer and the Conceptual Framework will become more complete and robust. Net income is quite an important performance measure for a certain accounting period, representing the amount belonging to the owners of an entity after paying all expenses including taxes. Acknowledging that it might be difficult to define the net income in such a way that everyone can accept, we respectfully encourage the IASB that the Board dare continue a challenge of defining net income, taking a step forward from the equation of "profit = income – expenses".

<u>Question 13—Reporting items of income or expenses in other comprehensive income</u>

Do you agree with the proposals on the use of other comprehensive income?

22. We find the paragraph 7.24 in the ED generally appropriate, which states that the presumption that all income and all expenses will be included in the statement of profit or loss can only be rebutted if: (a) the income or expenses (or components of them) relate to assets or liabilities measured at current values and are not of the type described in paragraph 7.23(b); and (b) excluding those income or expenses (or components of them) from the statement of profit or loss would enhance the relevance of the information in that statement for the period. In our survey, 63% of the respondents agreed with the proposals on the use of OCI (see Q6 in the Appendix).

23. However, the most of the CAC members are deeply concerned that the descriptions on the timing when "the use of other comprehensive income would enhance the relevance of the information in the statement of profit or loss" are insufficient, leaving the room for accounting treatments widely diversified depending on its interpretation. We would propose the IASB to revise the descriptions in paragraph 7.24 to eliminate such a concern. We reiterate the necessity of defining net income in the Conceptual Framework, which would naturally make the role of the OCI clearer in the statement of the financial performance.

<u>Question 14—Recycling</u>

Do you agree that the Conceptual Framework should include the rebuttable presumption described above?

24. We have divided opinions on the IASB's proposals of the rebuttable presumption. In our surveys, 34% supported the proposals, while 40% did not support the proposals, and the remaining 26% answered that they "could not decide at this moment". Neither answer gathered a majority (see Q8 in the Appendix).

25. In our comment letter to the DP, we provided the following opinions on recycling.

"We think 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. We think clear distinction of retained earnings and AOCI will make for relevant financial reporting."

26. We acknowledge that the IASB's view has got closer to ours mentioned above as suggested by the paragraph 7.26, which states, "If income or expenses are included in other comprehensive income in one period, there is a presumption that it will be reclassified into the statement of profit or loss in some future period. That reclassification occurs when it will enhance the relevance of the information included in the statement of profit or loss for that future period." It is our regret, however, to find that the IASB include the rebuttable presumption. As mentioned in our above comment on the recycling, we believe that all valuation gains and losses recorded as OCI should be recycled without the rebuttable proposition but with the proposition which always hold true. We would propose to delete the rebuttable presumption in the paragraph 7.26 to make that paragraph to require full recycling of the OCI.

27. The paragraph 7.27 states "The presumption that such a reclassification will occur could be rebutted, for example, if there is no clear basis for identifying the period in which reclassification would enhance the relevance of the information in the statement of profit or loss. If no such basis can be identified, this may indicate that the income or expenses should not be included in other comprehensive income." We are seriously concerned that the paragraph 7.27 would make practices widely

diversified because it describes the rebuttable cases only insufficiently. Accordingly, we propose fully deleting paragraph 7.27 because the rebuttable presumption is not necessary in the point of view of full recycling.

28. We expect the opposition against our proposal, criticizing that the revised paragraph 7.26 does not provide the clear trigger of recycling by itself. We would counter-argue this criticism, however, that it is sufficient for the objective of the Conceptual Framework to indicate that the full recycling is a basic concept, which the revised paragraph 7.26 would in fact mean. We believe that the optimal trigger should be determined standard by standard basis in accordance with the objective of each specific standard.

If you have any questions or need further elaboration, please do not hesitate to contact Makoto Kaimasu, Executive Vice President, SAAJ (m-kaimasu@saa.or.jp).

Sincerely yours,

Keiko Kitamura

Keiko Kitamura

Chair

Corporate Accounting Committee

APPENDIX

Results of SAAJ Survey on "Conceptual Framework for Financial Reporting"

Background and methodology

The Securities Analysts Association of Japan (SAAJ) sponsored a study session on IASB's Exposure Draft (ED) "Conceptual Framework for Financial Reporting", inviting lecturers from the Accounting Standards Board of Japan (ASBJ). Some 65 of our certified members participated in the session held on 3 August. A questionnaire was subsequently sent to each participant and 35 responded, making for a 54% 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: Chapter 2 in the ED reintroduces an explicit reference to the notion of "prudence" included in the former "Conceptual Framework for Financial Reporting" prior to the amendment of 2010.

Do you support the descriptions "Neutrality is supported by the exercise of prudence" and "Prudence is the exercise of caution when making judgements under conditions of uncertainty"?

(a) Yes	29	82.8%
(b) No	1	2.9%
(c) Cannot judge at this moment	5	14.3%
Total	35	100.0%

Q2：Recognition criteria in Chapter 5 of the ED eliminates a probability criterion that "it is probable that any future economic benefit associated with the item will flow to or from the entity", and describes that "An entity recognizes an asset or a liability if such recognition provides users of financial statements with: (a) relevant information, (b) a faithful representation, and (c) information that results in benefits exceeding the cost of providing that information".

Do you agree with the proposed approach to recognition?

(a) Yes	13	37.1%
(b) No	13	37.1%
(c) Cannot judge at this moment	9	25.7%
Total	35	100.0%

Q3：Chapter 6 of the ED describes that it categories measurement bases as historical cost or current value and current value measurement bases includes fair value in the perspective of market participants and value in use for assets and fulfillment value for liabilities in the perspective of entity.

Do you think the categorization correctly identifies the measurement bases?

(a) Yes	28	80.0%
(b) No	2	5.7%
(c) Cannot judge at this moment	5	14.3%
Total	35	100.0%

Q4：Chapter 6 of the ED describes that "when selecting a measurement basis, it is important to consider what information that measurement basis will produce in both the statement of financial position and the statement(s) of financial performance and to consider (a) how an asset or a liability contributes to future cash flows and (b) the characteristics of the asset or the liability."

Do you think these are appropriate as the factors to consider when selecting a measurement basis?

(a) Yes	21	61.3%
(b) No	6	16.1%
(c) Cannot judge at this moment	8	22.6%
Total	35	100.0%

Q5：Chapter 7 of the ED proposes that "Income and expenses in the statement(s) of financial performance are classified into either (a)the statement of profit or loss which includes a total or subtotal for profit or loss or (b) other comprehensive income" and describes that "Income and expenses included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period."

Do you support the IASB's proposals on the statement of profit or loss?

(a) Yes	23 人	65.7%
(b) No	2	5.7%
(c) Cannot judge at this moment	10	28.6%
Total	35	100.0%

Q6：Chapter 7 of the ED proposes that "when excluding income or expenses related to assets and liabilities measured at current values from the statement of profit or loss would enhance the relevance of the information in that statement for the period, those income or expenses are included in other comprehensive income."

Do you agree with the IASB's proposals on the use of other comprehensive income?

(a) Yes	22	62.9%
(b) No	7	20.0%
(c) Cannot judge at this moment	6	17.1%
Total	35	100.0%

Q7 : While the CAC in our comment letter "re: Comments on Discussion Paper "A Review of the Conceptual Framework for Financial Reporting"" submitted in January 2014 opined that net income and other comprehensive income should be defined as the elements of financial statements, Chapter 4 of the ED does not describe net income or other comprehensive income as the elements.

Do you think net income and other comprehensive income (especially net income) should be defined as the elements of financial statements?

(a) Yes	19	54.3%
(b) No	6	17.1%
(c) Cannot judge at this moment	10	28.6%
Total	35	100.0%

Q8 : The CAC in our comment letter to the DP opined that all valuation gains and losses recorded as OCI should be recycled to net income. Chapter 7 of the ED describes that "If income or expenses are included in other comprehensive income in one period, there is a presumption that it will be reclassified into the statement of profit or loss in some future period." In other hand, it also describes that "The presumption that such a reclassification will occur could be rebutted, if there is no clear basis for identifying the period in which reclassification would enhance the relevance of the information in the statement of profit or loss."

Do you agree with the IASB's proposals of the rebuttable presumption on recycling?

(a) Yes	12	34.3%
(b) No	14	40.0%
(c) Cannot judge at this moment	9	25.7%
Total	35	100.0%