September 18, 2008

Opinion on "Reducing Complexity in Reporting Financial Instruments"

Japanese Bankers Association

The Japanese Bankers Association would like to express its thanks for this opportunity to comment on the Discussion Paper " Reducing Complexity in Reporting Financial Instruments " published by the International Accounting Standards Board.

It is hoped that the following comments will assist the Board as it works to deliberate the project.

Section1: Problems related to measurement

> **Question1**
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> Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

Major changes like the "long-term solutions" outlined in this discussion paper are unnecessary.

Even if we grant that current rules are too complex, the primary reason for this has little to do with the rules themselves and more to do with the financial instruments they regulate, which (compared to things like inventory assets or fixed assets) come in wide varieties of objectives, types, terms, and counter values and in many cases are based on complex schemes and trading terms. Where we merely push ahead with the simplification of accounting rules, it would be to make it more difficult to understand from the accounting information what is actually happening with wide varieties of complex financial instruments and the companies that hold them. We would needlessly invite misunderstanding among the users of financial statements, and that is why such simplification is inappropriate. The damage from inappropriate financial statements carries risks that exceed the benefits to be derived from simplification.

Therefore, IASB should meet criticisms that "current rules are too complex" by responding that this view is "mistaken" and educating critics about why the complexity is "unavoidable." However, there is room for partial simplification and greater flexibility in hedge accounting requirements and practical measurement of theoretical value, and IASB should make improvements on those points.

Section2: Intermediate approaches to measurement and related problems

> **Question2**
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> (a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the

IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

(a) There is room for partial simplification and greater flexibility in hedge accounting requirements and practical measurement of theoretical value, and "intermediate approaches" should be investigated within that scope. However, we are opposed to studying all of the "intermediate approaches" outlined in this discussion paper because we are against inappropriately reducing the number of measurement categories for financial instruments, inappropriately codifying measurement at fair value and inappropriately eliminating hedge accounting.

(b) Among the standards presented in Paragraph 2.2, we are as a general principle in favour of (a), (c), and (d), but opposed to (b). In particular, within (b), we can tolerate the portion that reads, "It must not result in measuring instruments other than at fair value if they are required to be measured at fair value today," but the wording "Ideally, a change should increase the number of financial instruments measured at fair value" is inappropriate (especially if the increase is substantial) and should be deleted. With respect to the scope of measurement at fair value, we think that the current rules should in general be maintained. Our main reasons are that the current rules are able to express the substances related to wide varieties of complex financial instruments and to the companies that hold them, and they are already familiar to most. (See our response to Questions 8 and 9.)

Question3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

With respect to Approach 1, we propose that there should be virtually no amendment of existing measurement requirements. In other words, categories like "held-to-maturity investments" and "available-for-sale financial assets" express the substances related to wide varieties of complex financial instruments and to the companies that hold them and are each required, as they are in existing measurement requirements, in order to avoid useless confusion from a practical standpoint.

There may be room for partial amendment, for example, simplification or relaxation of tainting rules, but it is putting the cart before the horse to completely eliminate the "held-to-maturity" category for the purpose of simplification if this entails the full elimination of tainting rules.

Absorbing the "held-to-maturity" category into the "available-for-sale" category and integrating the two is said in the paper not to be a problem because there is no impact on net profit/loss, but there are impacts on net assets and financial instrument balance sheet, and this change would fail to express the substances, so the damages are greater than the benefits. In addition, absorbing and integrating the "available-for-sale" category (and "held-to-maturity" category) into the "trading" category is said not to be problematic because there is no impact on pricing of net assets and financial instruments on the balance sheet (in some cases), but there is an impact on net profit/loss and this change would fail to express the substances, so the damages are greater than the benefits.

Furthermore, "requiring all instruments that are traded in active markets to be measured at fair value" ignores the differences between this and holding to maturity. It would fail to express the substances and is therefore an inappropriate amendment. On the other hand, if there are virtually no amendments to the existing measurement requirements, all of the standards for intermediate modifications articulated in Paragraph 2.2 except for the inappropriate portion of (b) ("Ideally, a change should increase the number of financial instruments measured at fair value") are consistent.

Question4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(b) How should instruments that are not measured at fair value be measured?

(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?

(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?

It should be noted that we are opposed to Approach 2 itself and will therefore not be answering the specific questions in (a) through (e) because they assume agreement with Approach 2. Approach 2 says that "some financial instruments within the scope of a standard for financial instruments would be allowed to be measured using a cost-based method," which at first glance appears similar to existing requirements and methodologies and therefore justifiable. However, although Approach 2 adopts a fair value method as the measurement principle, an instrument within the scope of a standard for financial instruments would be allowed to be measured using a cost-based method if it meets exception criteria," which creates a cavalier hierarchy that would invite needless misunderstanding and is therefore inappropriate. In any case, the important points will be the specific instruments to which exceptions are applied and the specific requirements for applying them, and for this to be appropriate there would need to be detailed rules on par with existing rules, which would do little to reduce the complexity of accounting standards.

Question5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

   (i) Which method(s) should the IASB consider, and why?

   (ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure that your comments are consistent with your suggested approach to changing measurement requirements.

(a) Hedge accounting should not be eliminated. We support the opinion of financial statement preparers found in the latter half of Paragraph 2.33 that "[when] disclosing the effects of hedging activities in financial statements...the resulting volatility in earnings does not reflect the economic consequences of hedging activities." This is particularly the case for financial institutions that make wide use of derivatives to which hedge accounting is applied. Excessive and artificial volatility in net profit/loss is inappropriate not only for financial statement preparers, but also for financial statement users.

(b)

(i) We support the approach in Paragraph 2.35 (b) to "permit recognition outside earnings of gains and losses on financial instruments designated as hedging instruments." This is the approach used in the existing Japanese standards and it is familiar to us.

(ii) At the current point in time, we do not see anything of particular importance that we should identify.

Question6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?

(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?

(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.

(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

(a) Financial institutions that perform risk management for financial instruments on a portfolio basis should be allowed to apply hedge accounting that is suited to their management approach. (We support the argument in Paragraph 2.89.)

(b) This includes the existence of restrictions. There is a need for certain reasonable restrictions on hedge accounting, for example designation and documentation of hedges. However, excessively strict and detailed requirements are inappropriate from the perspective of cost-effectiveness. Given the potential size of the damages, restrictions should have sufficient rationality.

(c) Partial hedges should be recognized. There are many different kinds of risk to be hedged (for example, interest-rate risk, credit risk, foreign-exchange risk) and depending upon the type of risk there may not necessarily be sufficient means of hedging (sufficiently effective means of hedging) that would warrant the application of hedge accounting. There are also risks that cannot be hedged at all (liquidity risk, etc.). Were partial hedges not to be recognized, then as noted in Paragraph 2.72, it would be more difficult to make use of hedge accounting. Ensuring the utility of selective, dynamic hedge operations, including the determination of hedge ratios, is important to financial statement preparers (management, etc.) in maintaining and increasing corporate value. Were accounting rules to have "reduced complexity" that impairs corporate value, it would be to the disadvantage of shareholders, creditors, and other financial statement users.

(d) At the current point in time, we do not see anything else of particular importance that we should identify (other than the responses to (a) through (c) above).

Question7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

At the current point in time, we do not see anything of particular importance that we should identify.

Section3: A long-term solution—a single measurement method for all types of financial instruments

Question8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

We do not consider it appropriate to use a single methodology to measure all types of financial instrument that fall within the scope of a standard. Our main reasons are that the use of a single measurement approach would, in comparison with the existing measurement approaches, fail to express the substances related to wide varieties of complex financial instruments and to the companies that hold them and would invite misunderstanding among financial statement users while also creating needless confusion at the practical level.

This can be seen just from the perspective of term. Financial instruments could, depending upon the nature of the instrument and the purpose for holding, extend anywhere from intraday to several decades or semipermanent holding (or a high probability of that). Similarly, from the perspective of fluctuations in cash flow and value, the nature of the financial instrument and the economic environment may result in some instruments that experience (or have a high probability of experiencing) virtually no change in price from the time at which they are generated/acquired to those with infinite potential for price increases and those with the risk of becoming valueless. It fails to express the substances if one tries to use a single approach to measure them, whether that approach be fair value that assumes all instruments to be settled in cash on term end or be acquisition cost that assumes all instruments to be retained stably over the long term.

Furthermore, were we to apply fair value or some other single approach to the measurement of assets, liabilities, earnings, and expenses on the financial statements, then there would be the continued need to present to financial statement users the breakdown of the components in the profit/loss structure and other cost information to the same degree as currently done, an issue that is touched on in Paragraphs 3.29, 3.30, 3.49, 3.50, 3.63, 3.64, 3.82–3.84 in the discussion paper. This would likely make it inevitable that additional, supplementary information is disclosed in footnotes, and from a general, overall perspective would be unlikely to result in a "reduction of complexity" compared to current accounting standards and practices.

In addition, requiring the use of an one-size-fits-all, general purpose measurement of fair value would in many cases entail extreme complexity or significant costs in order to make frequent, short-term measurements of theoretical value or other forms of fair value with high degrees of precision. This would increase the practical issues for financial statement preparers, and rather than providing financial statement users with more relevant information, could potentially make information less relevant.

We do not believe that a separate approach to long-term solutions for measurement problems exists with respect to measurement-related accounting standards (excluding existing accounting standards and partial improvements) (see also our response to Question 9 (b)).

Question9

Part an of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

(a) We do not believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments. (For reasons, see our responses to Questions 8 and 9 (b).)

(b) We do not believe that there is a measurement attribute other than fair value that is appropriate for all types of financial instruments within the scope of a standard for a financial instrument and would provide a single, one-size-fits-all, general-purpose methodology (see our response to Question 8). In other words, we believe that the only appropriate approach is a mixture of measurement attributes as is generally the case with current practices in which some measurement attributes are appropriately measured in terms of fair value, while others may be properly measured on the cost-based method, and amortization cost or some other attribute. Our main reasons are that the existing mixed measurement attributes are able to express the substances related to wide varieties of complex financial instruments and to the companies that hold them and are already familiar to most.

While recognizing the possibility that the current mixed measurement attributes may not be able to (significantly) reduce the complexity involved in current measurement, this is not a defect only in the current mixed measurement attributes (see our response to Question 8) and is unavoidable. Indeed, we do not think that reducing complexity is the single or the most important issue or goal (see our response to Question 1).

Furthermore, the current mixed measurement attributes generally provide users with the information necessary to evaluate cash flow projections for virtually all types of financial instrument (there may be room for some improvements in part, but at least this is the case compared to other major measurement attributes).

Question10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

Section 3 generally covers our major concerns about fair value measurement of financial instruments. However, as a practical matter for financial statement preparers, we would add to the issues described in Section 3 questions of the frequency of measurement (accounting cycle, etc.) and the deadlines (work period for closing account, etc.), which we also consider to be significant points in fair value measurement of financial instruments.

In other words, coverage, methodology, and precision are all important questions in measurement, but even if those are constant, an increase in the frequency of measurement or tighter deadlines for measurement can be significant practical concerns, and we therefore advocate a cautious approach that takes account of the substances, impacts, and cost-benefit analysis.

Furthermore, in the future, we are concerned about the potential for similar fair value measurement requirements to be applied (scope expanded) to other areas besides financial instruments (for example, 3.94, A 39, A 49, A 51; some areas of fixed assets and inventory assets) in light of the nature of instruments and categories of holding purposes. In such cases, there would need to be some degree of consistency in measurement methods and precision between these new areas and financial instruments, and we are concerned about the extent of this and whether adaptation would be possible. Our primary concern is that this may be problematic in terms of the impact on the utility, consistency, and practicality of accounting information.

Question11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

(a) At the current point in time, we do not see anything of particular importance that we should identify.

(b) At the current point in time, we do not see anything of particular importance that we should identify.

Question12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

We believe there is room for some simplification and flexibility regarding hedge accounting requirements, practical measurement of theoretical value and information disclosure in footnotes, but we also think that more emphasis must be placed on cost-benefit analysis from practical perspectives and that doing so would enable simplification and greater flexibility for some of the excessively detailed and complex rules and procedures currently used.

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