

Accounting Standards Board of Japan (ASBJ)

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Financial Accounting Standards Board
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LETTER OF COMMENT NO. 19

Comments on the Preliminary Views
“Financial Instruments with Characteristics of Equity”

Dear Sirs/Madams,

We appreciate the FASB’s efforts on the Liabilities and Equity project for many years and welcome the opportunity to provide comments on the Preliminary Views “Financial Instruments with Characteristics of Equity”. The following comments are those of the International Issues Standing Committee of the Accounting Standards Board of Japan.

I General Comments

1. We support distinguishing between liabilities and equity focusing on the claims of residual interest holders of an entity and agree that the FASB (hereafter “the Board”) will continue its deliberations based on the basic ownership approach.
2. The Preliminary Views (hereafter “the PV”) does not propose a view for the subsequent measurement for perpetual instruments other than basic ownership instruments (hereafter “other perpetual instruments”) classified as liabilities under the basic ownership approach (paragraph 34 of the PV). Although we have not examined in detail as to whether such instruments should be classified as liabilities or equity, we note that subsequent measurement problems may be avoided by classifying these items as equity.
3. The Liabilities and Equity project addresses issues which go beyond specific standards level. This project should be undertaken in line with the Conceptual Framework project once the direction of the project has been fixed.
4. The distinction between liabilities and equity originally has been considered to have two objectives. The first objective is to present claims of residual interest holders, and thereby determining an entity’s net income. The second is to present the solvency relationships among claims, that is, to present the order of subordination among the claims. The basic ownership approach assists in achieving the first objective. However, we are of the view that the information related to the solvency relationships is widely used and is important. Accordingly,

we are of the view that it is necessary to promulgate specific presentation, formats, and footnote disclosures to present such relationships. In this respect we are of the view that attention should be paid to progress of the Financial Statement Presentation project.

II Responses to individual questions on the basic ownership approach

Q1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

5. We understand that the basic ownership approach would distinguish liabilities and equity focusing on claims of residual interest holders.
6. In Japan, an entity classifies as liabilities obligations with little or no discretion to avoid transferring cash or other assets to other parties, and the remaining items in the creditor's side of the balance sheet are classified as net assets. Within net assets items attributable to the parent company's shareholders are classified as owners' equity (See the Appendix of this comment letter for details). It is generally thought, whether someone is a shareholder depends on whether he or she has a residual interest, i.e. whether he or she is entitled to what is left over from the entity's activities. Owners' equity in the Japanese approach is not necessarily the same as equity in the basic ownership approach because the former focuses on the claims of parent company's shareholders and does not focus only on the most residual claims. However, the distinction clarifies that income is determined from the perspective of owners and, in that sense, the Japanese approach is similar to the basic ownership approach.
7. The basic ownership approach also proposes not to include indirect ownership instruments settled by issuing related basic ownership instruments in equity. We agree to this proposal. It is our understanding that these instruments have mainly introduced complexity in the distinction between liabilities and equity, so we expect that the proposed approach would simplify related accounting standards. Moreover, holders of such instruments are not owners of the entity.
8. We agree that the Board will continue its deliberations based on the basic ownership approach. At the same time we have some concerns about the approach. In that respect, please see our responses in Q3 and Q8.

Perpetual Instruments

Q2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments,

such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

9. In Japan, in practice, instruments which must be classified as owners' equity are determined by the Companies Act. As mentioned in the response to Q1, the Japanese approach is different from the basic ownership approach in terms of who is considered to be an owner. For example, other perpetual instruments issued in the legal form of stock are classified as owners' equity.
10. The amount of stated capital in owners' equity (see Appendix of this comment letter) determined by the act is widely used in regulatory systems. A change of items currently included in owners' equity has significant effects on those systems including law and would require coordination. Such coordination might be required in other jurisdictions. We are going to make necessary efforts for such coordination while contributing to the Board's discussion in its process toward convergence.
11. As in the response to Q3, our concern is that the Board proposed that other perpetual instruments be classified as liabilities without indicating the subsequent measurement. The distinction between liabilities and equity defines income, so such distinction is closely linked with measurement. Accordingly we are of the view that the Board should not determine how to classify instruments without solving the problem of measurement.

Q3. The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

12. Paragraph 34 of the PV indicates three possibilities about subsequent measurement of other perpetual instruments classified as liabilities.
13. Firstly, the alternative (a) would be suitable if dividends to basic ownership instruments and other perpetual instruments are objectively distinguished by a specified formula every year or holders of those instruments normally receive almost a constant amount of dividends every year. However, if dividends to other perpetual instruments are determined in general shareholders meetings, net income attributable to holders of basic ownership instruments are determined by eliminating those dividends to other perpetual instruments which are determined at the entity's discretion. We are of the view that such net income information would not be useful for estimating future cash flows or the value of an entity. Currently, net income attributable to holders of basic ownership instruments is disclosed in two steps: firstly, net income attributable to equity including both basic ownership instruments and other perpetual instruments is

presented in the income statement, and then, in EPS disclosure, net income attributable to basic ownership instruments is derived by reducing income attributable to other perpetual instruments using a simple formula.

14. The alternative (b) includes a fundamental problem regarding the valuation of claims. Enterprise value is the total value of operating investments (capital value or value in use) and the fair value of net financial investments. This enterprise value is allocated to each claim (debt and equity securities). If the objective of issuing a debt or equity security which has no market is not to gain short-term profit taking advantage of price fluctuation, and management reports the fair value of the security with its change recognized in net income, that would mean that management would be presenting its view about the enterprise value for investors. This is inconsistent with the fundamental concept of financial reporting system assuming that investors themselves estimate the enterprise value based on profit information.
15. Lastly, the alternative (c) emphasizes the possibility of economic redemption in spite of the perpetuity of the instruments. Their value would be calculated by determining the expected retirement date and expected dividend stream and discounting them. Such a method would be suitable if one can reasonably estimate the probability of redemption; otherwise it is not suitable because, as in the case of the alternative (a), the discretionary amounts would be reported as net income attributable to holders of the basic ownership instruments and such net income information would not be useful for estimating future cash flows or the value of an entity.
16. We are concerned that the Board tentatively decided that other perpetual instruments would be classified as liabilities without resolving subsequent measurement. We do not have a firm view on whether such instruments should be classified as equity, but we note here that the measurement issue could be avoided by classifying such instruments as equity.

Redeemable Basic Ownership Instruments

<p>Q4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?</p>
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17. The phrase “impair the claims” in paragraph 20(b) of the PV is not clear as to what kind of situation is assumed, because, generally, redemption of a basic ownership instrument is likely to impair other claims, that is, the redemption is likely to reduce the values of remaining instruments via a lower capital adequacy ratio and raising its financing cost. If the Board’s intention is to simply require that an entity should secure assets for redemption of instruments with higher priority, it would be better to describe specifically what the Board means.

Separation

Q5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

18. The following comments assume that an entity promises to pay dividends based on a specified formula to the holders of basic ownership instruments and that such dividends payable is accrued contrary to current accounting. In Japan such dividends payable would not become a legal obligation of the entity until they go through legal processes as an approval at the general shareholders meeting.
19. The entity is expected to pay dividends to shareholders following the formula, but the entity may not make a payment due to lack of distributable surplus. Therefore, it seems inappropriate to say that accrued dividends payable based on the formula are such obligations to transfer cash or other assets to another party that the entity has little or no discretion to avoid. The situation is different from the payment of interests on bonds.
20. We are of the view that it is preferable to classify such accrued dividends payable as equity, because the probability of a payment in the case of liquidation is quite low and these payables have a subordinate nature.

Substance

Q6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

21. We do not object to such a requirement, because its intention is to reflect the economic

substance of the instrument. However, it may conflict with other explicit requirements. Accordingly, in practice, its implementation would have to be limited to cases where economic substance is clearly different from what is assumed in the explicit requirement.

22. As in the response to Q3, we do not have a firm view regarding whether other perpetual instruments should be classified as equity. But if such instruments were classified as equity, one possible example of factors or circumstances other than the stated terms of the instruments that could change an instruments' classification or measurement under the basic ownership approach would be economic compulsion of perpetual dividend preferred share with increasing rate of dividend.

Linkage

Q7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

23. As in the response to Q6, such requirement may conflict with other explicit requirements. Accordingly, in practice, its implementation would have to be limited to cases where economic substance should clearly be considered. Imposing certain restrictions like those in paragraph 43 of the PV to identify such cases is necessary.
24. In the example of page 14 of the PV the entity should link the instruments and account for them as a single puttable share, not separately as a common share and a put option, when these three instruments are available. On the other hand, there is another requirement to separate elements which result in different accounting treatments. For example, a hybrid financial instrument in paragraph 12 of FAS 133 "Accounting for Derivative Instruments and Hedging Activities" is separated into a host contract and an embedded derivative even if these two elements are in one contract. Therefore, it is useful if the Board clarifies when to link or separate such elements when instruments are composed of several elements, and considers what should be regarded as an "element".

Measurement

Q8. Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

25. The PV proposes that instruments within the scope that have varying or uncertain settlement amounts, for example, options and forward contracts on the issuer's basic ownership

instruments would be remeasured at fair value at each measurement date unless another standard permits or requires a different measurement attribute (paragraph 35 of the PV). We acknowledge that there are situations where it is suitable that such instruments are remeasured at fair value and their changes in value are reported in net income, but we are not convinced that this treatment should be extended to all situations. Consider a case when an entity receives cash in exchange for issuing warrants for the purpose of financing. The warrants are more likely to either (a) be exercised to form a part of share capital or (b) remain until expiry rather than be closed out. It would be of little use to report fluctuations of fair value of such warrants in the income statement at each measurement date.

26. Possible perspectives from which an entity may determine measurement attributes of such instruments may be settlement methods (whether by cash or by issuer's share), availability of fair values, business constraints for disposal, the existence of a redemption date.
27. There are some cases where an issuer or a holder has an option to choose the settlement method. Our comment does not address such cases, since they require further analysis.

Presentation Issues

Q9. *Statement of financial position.* Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

28. We are of the view that it is sensible to distinguish items within equity according to the existence of redemption requirements.
29. It is useful to present information about the liquidity requirements of the reporting entity for liabilities. It is useful to display whether an item includes a present obligation to deliver cash or other assets that an entity has little or no discretion to avoid, which is adopted as the liability definition in the current conceptual framework. In terms of assessing solvency, such information would be all the more necessary if other perpetual instruments are classified as liabilities. We are of the view that it is necessary to promulgate specific presentations, formats and footnote disclosures. In addition, the Financial Statement Presentation project is now discussing how liquidity information should be presented and disclosed, so the Liabilities and Equity project should also take into consideration the outcome of that project as appropriate.
30. Table 2 of Appendix C of the PV indicates that instruments within the scope of the PV would be

remeasured at redemption value not only when they are puttable at fair value (No. 17) but also when they are callable at a fixed price (No.19). We would like to confirm whether an instrument would not have to be remeasured when they are callable at fair value contrary to the cases of No.17 and No.19, . If not, note disclosures might be necessary because such instruments affect potential cash outflow.

Earnings per Share (EPS)

Q11. The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

31. Firstly, we are of the view that the Board should clarify whether the intended users and the objective of EPS information is affected by the PV. The following comments are prepared on the premise that the users and the objective are similar to those for existing EPS information.
32. Common shares would presumably be basic ownership instruments in most cases, but they are not defined exactly in the same way. Moreover, basic ownership instruments issued by subsidiaries may be basic ownership instruments in the context of consolidated financial instruments (See also paragraph 36 of this comment letter). The Board should consider whether the definition of common shares that goes to denominator of the EPS calculation needs to be modified in terms of the accounting standard to be issued based on the PV.
33. The amount of retained earnings would change by remeasuring redeemable basic ownership instruments (See the example in page 10 of the PV). It may be necessary to add that this change needs not be adjusted to determine income attributable to basic ownership instrument holders in the EPS calculation.
34. An instrument classified as a liability, which has preferred claims to assets in liquidation, may have the same dividend claim as the basic ownership instrument. We are of the view that it is necessary to discuss whether an entity should treat that instrument in the same way as a basic ownership instrument in the context of EPS calculation.

Other comments

Interaction with other projects

35. The Liabilities and Equity project addresses issues which go beyond specific standards level. As already recognized in the PV, this project is closely related to other projects such as the Financial Statement Presentation project and the Conceptual Framework project. Especially, the

latter would interact with the Liabilities and Equity project through the definitions of liabilities and equity. This project should be undertaken in line with the Conceptual Framework project once the direction of the project has been fixed.

Basic ownership instruments issued by subsidiaries

36. It is our understanding that basic ownership instruments issued by subsidiaries (and consolidated variable interest entities) would usually not have the two characteristics in paragraph 18 of the PV in the context of the consolidated financial statements. Holders of such instruments have claims to assets of the issuing subsidiaries only and do not have claims to those of their parent or other subsidiaries unless a particular condition exists, and therefore subordination or preference of the instruments would not be determined legally in light of the consolidated group (see paragraph 18(a), footnote 2). In addition, although paragraph 18(b) says “The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied”, the holders are not entitled to a percentage of the assets of the consolidated group. Taking these into account, our understanding is that basic ownership instruments issued by subsidiaries usually do not retain their basic ownership nature in the context of the consolidated financial statements. However, this understanding may not be what the Board has intended, considering the statement in paragraph 29 of the PV, so we would like to suggest that the characteristics stated in paragraph 18 (a) and (b) be revised.
37. If, contrary to our understanding in the preceding paragraph, basic ownership instruments issued by subsidiaries still retain its basic ownership nature in consolidated financial statements, such instruments should be presented separately from basic ownership instruments issued by their parent in the equity section of the consolidated balance sheet. The nature of instruments issued by subsidiaries is different from the nature of those issued by the parent because instruments issued by subsidiaries only have claims to the assets of the issuing subsidiaries only.

Accounting for convertible bonds

38. A convertible bond is classified as a liability both under the basic ownership approach and under current accounting guidance. Paragraph 35 of the PV proposes that instruments for which there are no existing measurement requirements be measured using existing framework. Following this proposal, an entity would account for convertible bonds in accordance with existing requirements and would not remeasure them at fair value at each reporting date. On the contrary, Table 2 of Appendix C states that convertible bonds would be remeasured at fair value and its change in value would be reported in income. We question if this treatment is consistent with the proposal in paragraph 35 of the PV.

39. Moreover, if, like IAS 32 “Financial Instruments: Presentation”, an entity separately recognizes components of the convertible bond that corresponds to (a) the bond element and (b) the conversion option that grants holders a right to convert it into an equity instrument of the entity, financing costs would be reflected in income through accretion of the bond element by adopting the same accounting treatment as the straight bond and an entity would not have to take trouble to remeasure the instrument at fair value. Thus, we are of the view that to separate these two elements and account for them separately is a possible treatment to be considered.

A definition of a financial liability

40. It may be useful to clarify how the definition of a financial liability (paragraph 6(c) of FAS 159 “The Fair Value Option for Financial Assets and Financial Liabilities”) would change, which is not described in the PV.

We hope that our comments will contribute to the future deliberations of the FASB.

Sincerely yours,

Take Arai

Takehiro Arai

Chairman, International Issues Standing Committee

Board Member (full-time), Accounting Standards Board of Japan

Appendix: Presentation on the creditor side of the balance sheet currently adopted by the ASBJ

The ASBJ Statement No. 5, "Accounting Standard for Presentation of Net Assets in the Balance Sheet" was released in 2005 to implement a new presentation format of the balance sheet, which has been effective for fiscal years ended after May 1, 2006. Major points are summarized as follows.

- (a) The balance sheet is divided into three sections: Assets, Liabilities, and Net Assets.
- (b) The Net Assets section is composed of owners' equity and other items (valuation and translation adjustments, subscription rights to shares, and minority interests (non-controlling interests)).
- (c) Changes in owners' equity other than transactions with owners in their capacity as owners ties into net income.
- (d) Although comprehensive income is not presented, the total amount of comprehensive income can be derived from information in the statement of changes in Net Assets.

The basic concept of the ASBJ Statement No. 5 is the same as the conceptual framework discussion paper.

- First, Liabilities are determined by the existence of an obligation and the remaining items of the creditor side of the balance sheet are classified as Net Assets. Second, interest attributable to the parent company's shareholders is determined as "owners' equity" in Net Assets. Thus, broadly speaking, the creditor side of the balance sheet results in three categories (liabilities, owners' equity, and other items).
- Other items include warrants, accumulated gains and losses of available-for-sale securities, and minority interests (non-controlling interests). Net income corresponds to owners' equity and comprehensive income (if presented) corresponds to Net Assets. This correspondence achieves the clean surplus relationship.

Presentation of net assets section based on ASBJ Statement No. 5

Net Assets
Owners' equity
Stated capital
Capital surplus
Earned surplus
<i>Valuation and translation adjustments</i>
Subscription rights to shares
Minority interests
Total Net Assets