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International Accounting Standards Board
30 Cannon Street
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Comments on the Supplementary Document, *Financial Instruments: Impairment*

To the Board Members:

The Japanese Institute of Certified Public Accountants (“we” and “our”) appreciates the continued efforts of the International Accounting Standards Board (IASB) on the financial crisis, and welcomes the opportunity to comment on the Supplementary Document, *Financial Instruments: Impairment*.

Impairment of financial instruments has significant effects in practice. In light of this, we hope that the final standard will be issued by June 2011, the target date for project completion, after careful deliberations of the issues in the supplement and other issues arising from the perspective of operational practicality.

General

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

Comment:

We believe that the document deals with the weakness. We are concerned, however, about the minimum allowance amount (floor). Please see our comment to Question 9.

Scope – Open portfolios

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

Comment:

We believe it is operational.

However, the impairment model proposed in the supplementary document was developed because the model originally proposed in the Exposure Draft (ED) was unsuitable for open portfolios. For this reason, we believe that the original model should continue to be generally applied to closed portfolios, and the model proposed in the supplementary document should be considered as an exception to that original model. We also believe that, from the perspective of operational practicality, the IASB should clarify the scope of the supplementary document and provide more practical guidance.

Differentiation of credit loss recognition

Question 3

Do you agree that for financial assets in the ‘good book’ it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

Comment:

We agree.

We believe it is possible to recognize the impairment allowance for sound borrowers, since an average life of corporate loans is one to three years, and entities are required to recognize the minimum allowance amount (floor) for the foreseeable future (no less than twelve months) based on a “higher of” test. We do have concerns, however, about the minimum allowance amount (floor). Please see our comment to Question 9.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Comment:

If the provisions of the supplementary document are applied, the timing of the expected credit losses may diverge. If, however, the IASB assumes that the entities within the scope of the supplementary document, that manage financial assets on an open portfolio basis, are the financial institutions with large holdings of loans and debt instruments, any divergence in the timing of the expected credit losses would probably be immaterial. Hence, on the basis of the assumption, we support the proposal.

On the other hand, preparers may have difficulty in complying with paragraph 4, that is, the provision requiring that all estimates of expected credit losses also be updated in the preparation of the interim financial statements. We also believe that it would be useful, from an auditing perspective, if there was specific guidance on an initial estimate of expected losses when determining the impairment allowance, or on the method to be used for estimating the credit losses expected to occur within the foreseeable future.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

Comment:

We believe that it would provide useful information for decision-making, however, it may have difficulties as described in our comment to Question 4.

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Comment:

We believe it is clearly described.

Question 7

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Comment:

We believe it is auditable. That being said, there are jurisdictions that, like Japan, use terms similar to 'good book' and 'bad book' in relation to loan classifications for the purpose of the regulation of banks and other financial institutions. In these jurisdictions, the terms 'good book' and 'bad book' may be construed to have meanings different from those intended in the document. The accounting standard should be established to reflect the substance of an entity's credit risk management purposes, regardless of the regulatory criteria for the specific industry.

Operationally, it would be more clear if there were additional definitions for 'good book' and 'bad book'. In particular, we believe the IASB should provide examples of situations where "the collectability of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group, from receiving regular payments from the debtor to recovery of all or a portion of the financial asset". The standard should explicitly state, at a minimum, that 'bad book' applies when the debt restructuring takes place.

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Comment:

We agree.

Minimum impairment allowance amount

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Comment:

(a) We agree with the proposal, except for the following points.

We believe that the time-proportional approach proposed by the IASB is theoretical. The model should not be applied unless the expected credit loss over remaining life would surely be estimated. However, the estimation of expected credit losses involves some degree of uncertainty. Since, we also believe that it would be appropriate to establish a floor to respond to the “too little, too late” concerns with respect to the current impairment model under IAS 39 *Financial Instruments: Recognition and Measurement*. We believe this would be in line with the expectations of the users of financial statements, and we do not suppose it would introduce too much complexity.

That being said, we do not believe that the relevant period for the floor should be a foreseeable future. If entities were required to recognize losses expected to occur within the foreseeable future, then any entity with a superior ability to “foresee” the future would recognize higher allowances. The result may be unreasonable. Further, as described in (d) below, it would be difficult to foresee longer periods during unstable economic conditions. If, for example, a financial crisis such as the subprime mortgage crisis was to strike again, the significant uncertainties would shorten the foreseeable future period, which in turn would lower the amount of allowance recognized. This is counter-intuitive. Therefore, we believe that the IASB should define the floor as the amount of credit losses expected to occur within a certain period (e.g., twelve months), not the amount of credit losses expected to occur within the foreseeable future (required to be no less than twelve months). The latter depends on the ability of an entity to foresee and would be difficult to verify.

(b) We do not agree.

The supplementary document is applied to open portfolios. Assets are constantly added and removed to and from open portfolios. Even if a group of certain types of assets has an early loss pattern, it would not really be relevant to determine the remaining lifetime of the group of assets as a whole, as assets within an open portfolio generally have different lives. And for open portfolios, it would be extremely difficult, in practice, to determine whether there is evidence of an early loss pattern.

(d) We believe that the period considered in developing the expected loss estimate changes. In a stable economy, one can foresee a longer period on the assumption that the current situation will last for a longer period. But the more the economic conditions fluctuate, the more difficult it is to foresee a future period.

Flexibility related to using discounted amounts

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8 (a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Comment:

(a) We believe that an undiscounted estimate should be used when calculating the time-proportional expected credit losses. And, from the perspective of comparability, we do not agree that the option of using a discounted estimate should be permitted unconditionally.

When permitting the use of discounted estimate, we believe the expected loss should be the amount of contractual cash flows, including all future interest that an entity does not expect to collect (as opposed to the amount of principal the entity does not expect to collect at the measurement date). Otherwise, the use of the discounted estimate would result in lower total expected losses, compared to the total expected losses where an undiscounted estimate is used. The allowance would, therefore, be smaller, which we believe would be inappropriate.

Given that the time-proportional expected credit losses are only determined for the 'good book' as a simplified approach, we do not believe the standard needs to state whether the discount is permitted or not. It would be sufficient, in our view, to require disclosure as to whether or not a discount is applied and consistent application of the method to determine the discount rate.

(b) As mentioned above, we do not believe that entities should be permitted to use a discounted estimate. With this in mind, we do not agree, from a comparability perspective, to permit the use of "...any reasonable rate between (and including) the risk-free rate and the effective interest rate..." referred to in B10.

Approaches developed by the IASB and FASB separately

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

Comment:

The concept of the floor within the common proposal is like a obstructive factor in light of the framework of impairment measurement. We believe that the IASB approach is more consistent than the FASB approach from a theoretical perspective, consistent with the approach to revenue recognition. We believe, however, that the proposed common model is the result of the Boards placing a high emphasis on convergence. The balance between the IASB approach and the common model is appropriate, and we see no compelling reason to deny the proposed common model.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

Comment:

The recognition of expected losses for a certain period in the point-in-time under the FASB approach would lead to the recognition of day one loss. The treatment also differs from the business model to recognize revenue over the credit term. Hence, we fail to find a sufficient theoretical rationale for the FASB approach and reason why the FASB approach would be better than the common proposal.

IASB only Appendix Z
Impairment of financial assets

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

Comment:

We agree.

Given the practical difficulty of considering expected losses in the determination of the effective interest rate, we believe the separation is helpful from the perspective of the cost-effectiveness and timely disclosure. In addition, credit risk is generally managed separately from the interest income. Therefore, we do not believe the information would be any more useful if the expected credit losses were incorporated in the calculation of the effective interest rate for accounting purposes.

Scope – Loan commitments and financial guarantee contracts

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Comment:

We agree.

All loan commitments should be subject to the impairment requirements, since they are also considered in credit management.

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

Comment:

We believe they are operational. However, we see a need to add guidance when finalizing the standard, as no specific guidance is offered in the supplementary document as it stands now. It will also be necessary, in our view, to include paragraph AG4 of IAS 39 in the Application Guidance of IFRS 9 *Financial Instruments*.

Presentation

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

Comment:

We agree.

Yet the original ED proposed different presentation requirements. If the requirements in the original ED (which should be applied in principle) and the requirements in this supplementary document (which are exceptions) are both finalized in the standard, the adoption of either method would end up producing figures with different results meanings for the same entity. In addition, a lack of comparability between entities would result. We, therefore, believe that the standard should provide a single method of presentation. If the model proposed in the supplementary document were to be adopted, it would be impossible to present the financial statements in accordance with the requirements in the original ED.

It would be preferable, we believe, to present reversals as parentheses of impairment losses in the statement of comprehensive income or in the notes, since the amount of impairment losses would be presented as a net amount including reversals of impairment losses.

Disclosures

Question 18Z

- (a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

Comment:

(a) We agree.

We believe the proposed disclosure appropriately presents the relationship between an entity's credit risk management and its accounting treatment without imposing an excessive burden on the preparers of financial statements.

(b) Paragraph Z8 proposes that entities be required to disclose reconciliations in a tabular format for both the current annual period and the previous four annual periods for the impairment allowances determined in accordance with the time-proportional method. In view of the practical burden, we recommend that entities only be required to make this disclosure for two annual periods, including the prior period presented in the financial statements.

It would be useful in practice to have an illustrative example, since part of the disclosures may overlap when the disclosures are prepared in accordance with two separate sets of proposals, namely, those in paragraphs Z9-Z12 regarding the expected credit loss estimates, and those in paragraphs Z13-Z15 regarding the credit risk management.

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

Comment:

We agree.

For receivables transferred to the bad book, the foreseeable future period and the remaining life are considered to be almost the same when a transfer becomes necessary. We, therefore, believe it would be more appropriate to consider the element of the floor in addition to the proposed amount when determining the transferred amount. This, however, would lead to complexity in practice. In addition, given that the allowance balance for separate assets should be the amount of expected losses allocated to the period, the proposed method seems to strike an appropriate balance between theory and practice.

Yours faithfully,

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Executive Board Member—Accounting Practice (IFRS)

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