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Comments from the LIAJ on the Discussion Paper - *Fair Value Measurements*

We welcome the discussions held on a global scale with regard to the fair value in financial statements and also appreciate your giving us an opportunity to submit our comments on this occasion. As the measurement issue constitutes a core element among issues to be discussed in the IASB's projects and would have a significant effect on the direction of accounting standards to be developed in the future, we request that sufficient discussions be made taking into consideration the comments you receive from various constituents.

We understand that this Discussion Paper does not intend to change the scope of the fair value measurements and recognise that separate IASB project on insurance liability is currently underway. We also feel it necessary to carefully monitor the development of regulatory (supervisory) reporting on the measurements of insurance contracts.

We also recognise that there is an argument, in the IASB's discussions on the insurance projects, that there are no significant differences between current exit value, as discussed in the Insurance Project, and fair value. However, in our comments, we do not focus on insurance contract measurement issues; rather, we aim to respond more generally to the issues which may impact our present and future practices.

Therefore, we would like you to understand that our comments are formed separately from the question as to whether the concept of fair value should be applied to insurance contracts.

Please find our comments as follows:

[Application to IFRSs already using the "fair value"]

The term "fair value" is a generic word that may encompass various measurement bases, and it is uncertain whether the term could be consistently used in an appropriate manner in each country. Sufficient discussions will be essential when establishing a single uniform standard for all "fair values".

We appreciate that the IASB's aim of issuing this Discussion Paper is to establish a clear and single guidance that would help alleviate the complexity of procedures in measuring the fair value and thus would enhance consistency.

Nevertheless, the "fair values" used in the IFRSs which were issued prior to this Discussion Paper were not, as a matter of course, reviewed within the discussions of the Discussion Paper. Therefore the application of this guidance to each of those "fair values" will need to be reexamined individually.

We do not believe the methodologies described in this Discussion Paper would be appropriate for all circumstances where fair value is used in the existing IFRSs.

[Measurement Attribute]

Considering that other measurement attributes are accepted under the term "fair value" where an active secondary market does not exist, it would not be appropriate to define fair value as a current exit value in all situations. Where a market is liquid, stable in supply and demand and flexible in pricing, exit value could be an appropriate measurement attribute; however, in practice, such a situation is rarely the case except for financial assets. In the cases where a market is not liquid or that even a market itself does not exist, measurement attributes other than exit value needs to be considered within the framework of "fair value."

[Timing of Revenue Recognition]

In considering an alternative to define fair value as an exit value when the exit value at initial recognition is different from the transaction price, the implications of this treatment on revenue recognition need to be sufficiently considered. The Discussion Paper seems to assume that any differences between an entry price and an exit price must be recognised at initial recognition. However, in the Discussion Paper, whether such treatment is appropriate for accounting purposes is not clearly discussed.

When discussing the fair value measurement methods, sufficient considerations should be given to its implications on revenue recognition, including the consistency over the handling of contracts which provide services over the long term in the future.

[Entity's Own Estimate]

For those contracts which have no secondary market and involve uncertain future events, such as insurance contracts, we do

not think it is necessarily appropriate to apply a market participant's view based on hypothetical transactions in a hypothetical market to all cases.

In the absence of an observable market, using a preparer's estimate which reflects the entity's strategies or management technique in performing its obligation may often provide more useful information than using a hypothetical market average.

It is implied that risk free rates should be used to discount future cash flows to determine the fair value of a liability. These risk free rates should not be the yields of generally traded government bonds, but rates that reflect the characteristics of a liability, such as the timing, currency or liquidity of the cash flows.

[Credit Risk]

We do not believe that non-performance risk including credit risk should be considered in measuring the fair value of a liability. Financial statements that would present gains when an entity's own credit standing deteriorates and present losses when its own credit standing improves would be misleading and not useful. Moreover, considering its own non-performance of an obligation in measuring a liability would conflict with the assumption of going concern stated in Paragraph 23 of the IASB Conceptual Framework.

We, the LIAJ, pay our greatest respect to the IASB for its energetic efforts towards establishing international accounting standards including those for insurance contracts. We earnestly hope that our comments stated herein will be reflected in your future discussions and we are more than happy to provide you with further information when necessary.

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**The LIAJ's Comments on the IASB Discussion Paper
*Financial Instruments with Characteristics of Equity***

[Basic Stance]

1. As stated in Paragraph 13 of the IASB Discussion Paper "Financial Instruments with Characteristics of Equity", IAS 32 *Financial Instruments: Presentation* sets out the guidance for distinguishing between liability and asset instruments and equity instruments, and defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
2. In contrast, the FASB Preliminary Views "Financial Instruments with Characteristics of Equity" proposes three approaches for distinguishing equity instruments from non-equity instruments. These approaches will first determine which instruments should be classified as equity instruments.
3. We expect that the relevant standards, including the IASB conceptual framework, need to be finalized in a consistent manner. In this regard, the Discussion Paper addresses issues that go beyond specific standards-level.

[Evaluation of Three Approaches]

4. We are of the opinion that the basic ownership approach is the most appropriate among the three approaches proposed in the FASB documents because the distinction between equity and liability is clear and simple. It should be noted, however, that under the basic ownership approach "the most residual claim" is classified as equity while others are classified as liabilities, thereby classifying preferred stock as liabilities. We are concerned that such a definition might hinder diversification of financial instruments. Therefore, we propose that the definition of equity be expanded to include "the claims that have unconditionally¹ lower priority over any other ordinary claims regarding distribution of residual property", so that preferred stock should be classified as equity.

[Implications on Insurance Contracts]

5. We are aware that insurance contracts are not within the scope of either IAS 32 or the Discussion Paper. However, if the same distinction were applied to insurance contracts, the following issue might arise regarding discretionary future dividends.
6. As stated in Paragraph 247 of the IASB Discussion Paper "Preliminary Views on Insurance Contracts", the critical question for a participating contract in defining liability is whether the insurer has a present obligation to pay policyholder dividends. In this respect, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* identifies two categories of obligations as liabilities: legal obligations and constructive obligations; this is the case while amendments to IAS 37 have been under deliberation. We assume that the current discussion about the amendments will lead to a narrower definition of constructive obligation, such as the idea that the counterparty should have some legal remedy against the entity. This, consequently, may result in future dividends not being classified as liabilities in many cases.
7. On the other hand, the FASB has, in Paragraph 18 of its Preliminary Views, stated that a basic ownership instrument has both of the following characteristics: 1. The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and 2. The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. Assuming that accounting standards for insurance contracts are changed and that future dividends of participating contracts are recognized/measured at economic value, the amount measured as future dividends, even if uncertain or unclaimed parts are included, will be classified not as equity, but as liabilities because it does not meet the definition of basic ownership instrument under the Paragraph 18. Accordingly, unenforceable future dividends may be classified as liabilities. Furthermore, insurance contracts will be classified as liabilities and not as equity in each of the three approaches because

¹ Here we use the term "unconditionally" to exclude a class of claims that are subordinate to the ordinary class of debts under certain conditions from equity. Such subordinated debts shall be included in liabilities.

insurance contracts are neither perpetual instruments nor indirect ownership instruments.

8. Concerning a liability consistent with the basic ownership approach, the FASB states, in Paragraph D11 of Appendix D of its document, that “a claim does not have to create an obligation to be considered a liability (for example, perpetual preferred stock with no dividend requirement)”, and that the definition would be similar to “a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments”. Stated in Paragraph D13, one essential characteristic of a liability under the basic ownership approach is that if an entity's obligation is forgiven, that forgiveness would directly affect the assets available to holders of basic ownership instruments. If the definition suggested in D11 is applied to insurance contracts, an unenforceable part of policyholder dividends will be recognized as liabilities because the assets available to holders of basic ownership instruments will increase when policyholder dividends (of insurance contracts) are forgiven.

[Consistency with Other Standards]

9. We believe that once the direction of the preliminary views has been fixed, this project requires greater consideration regarding consistency with other ongoing projects, such as the Conceptual Framework, Financial Statements Presentation and amendments to IAS 37, especially in view of the above-mentioned points.
10. Moreover, definitions of financial liability instruments and financial equity instruments based on any of the three approaches (including the basic ownership approach) seem to be inconsistent with the current Conceptual Framework to a varying degree. Therefore, if the any of the three approaches is adopted to distinguish between financial liability instruments and financial equity instruments, we believe that the current Conceptual Framework should be reviewed and amended accordingly.

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**The LIAJ's Comments on IASCF
Review of the Constitution**

We, The Life Insurance Association of Japan (LIAJ), would like to express our greatest respect to the International Accounting Standards Committee Foundation (IASCF) and the International Accounting Standards Board (IASB) for your continuing efforts to develop high quality and global accounting standards, and to also extend our gratitude for providing us with an opportunity to present our comments on the IASCF "Review of the Constitution".

The LIAJ is a trade association comprised of all (45) life insurance companies operating in Japan. Its purpose is to promote sound development of the life insurance industry in Japan and maintain its reliability.

Monitoring Group

Q1. Do you support the creation of a link to a Monitoring Group in order to create a direct link of public accountability to official institutions?

(Response)

Basically, we agree to the creation of a link to the Monitoring Group in order to create a direct link of the IASCF's public accountability to official institutions.

Q2. The proposals contemplate a Monitoring Group comprising representatives of seven public authorities and international organisations with a link to public authorities. While recognising that the Monitoring Group is an autonomous body, the Trustees would welcome comments regarding the Monitoring Group's membership and whether other organisations accountable to public authorities and with an interest in the functioning of capital and other financial markets should be considered for membership.

(Response)

We support the proposals that contemplate that the Monitoring Group would initially be comprised of representatives of seven public authorities and international organizations with a link to public authorities. We believe that this composition reflects the interests of not only the authorities responsible for the adoption or recognition of financial reporting standards in major capital markets, but also of developing and emerging economies. The Monitoring Group should initially be comprised of the seven representatives and then, as described in the new Section 22, expansion of the membership could be reconsidered in the future if necessary.

Q3. The Trustees will remain the body primarily responsible for the governance of the organisation and the oversight of the IASB. Their responsibility to a Monitoring Group will enable regulatory and other authorities responsible for the adoption of IFRSs to review the Trustees' fulfillment of their constitutional duties. Does the formulation of the Monitoring Group's mandate and the Trustees' reporting responsibilities, as described in the proposed Section 19, appropriately provide that link, while maintaining the operational independence of the IASC Foundation and the IASB?

(Response)

The proposed changes to IASCF Constitution are rather vague as to the responsibility of the IASCF to the Monitoring Group. The Monitoring Group should have sufficient powers to provide the necessary oversight of the IASCF. An interaction between the Monitoring Group and the IASCF should be clearly set out in the Memorandum of Understanding exposed to public. Furthermore, the Monitoring Group should monitor the work of the IASCF effectively, and thereby monitor the work of IASB.

Q4. Given the proposed creation of a Monitoring Group, would there be a continued need for the Trustee Appointments Advisory Group in the selection of Trustees? If so, what should be the role and composition of the Trustees

Appointments Advisory Group?

(Response)

None

Expansion of IASB membership and geographical allocation

Q5. Do you support the principle behind expanding the IASB's membership to 16 members in order to ensure its diversity, its ability to consult, liaise and communicate properly across the world, and its legitimacy?

(Response)

In order to ensure the IASB's diversity, its ability to consult, liaise and communicate properly across the world and its legitimacy, we support the expansion of the IASB's membership. However, to do so, we believe that membership should not only be expanded, but that presumptive openness and/or more frequent implementation of field tests covering major markets should also be required.

Q6. Do you agree with the geographical formulation suggested by the Trustees?

(Response)

We support the geographical formulation of the IASB membership to ensure the IASB's diversity. We recommend that two members from any area, subject to maintaining overall geographical balance, should be appointed in a way that a composition ratio of the membership should be closely related to that of capital markets across the world.

Q7. The Trustees are suggesting that the Constitution should provide flexibility on the matter of part-time membership. Do you support that proposal?

(Response)

None

(Other comments)

A voting requirement should be a high-level requirement to enhance the reliability of standards adopted. Specifically, we support concept that the final standards should require approval:

- by nine (9) members if there are fewer than fifteen members;
- by ten (10) members if there are fifteen members; or
- by eleven (11) members if there are sixteen members.