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31 August 2011

Ms. Françoise Flores
Chairman of European Financial Reporting Advisory Group
35 Square de Meeûs
1000 Brussels
Belgium

Dear Françoise

<u>Comments on EFRAG DP "Considering the Effect of Accounting Standards"</u>

The Accounting Standards Board of Japan (ASBJ) is pleased to respond to the Discussion Paper (DP) "*Considering the Effects of Accounting Standards*" of the European Financial Reporting Advisory Group (EFRAG).

Although it has not been customary for us to respond to consultative documents from those organisations other than the IASB/FASB or the IFRS Foundation, we decided to share our views since this issue is particularly important for the IFRS Foundation and IASB to consider when designing future standard setting schemes. We hope that our comments would be conducive to advancing things forward. Accordingly, we are copying this submission to the leadership of respective bodies of the IFRS Foundation.

We strongly believe that the maintenance of independence is critical for accounting standards setters to deliver high quality outputs, whereas fulfilling the accountability is equally important. In this respect, we believe that 'effect analysis' is an essential element for a standard setter to fulfil its accountability. Therefore, we are pleased to see that the IASB published a comprehensive effect analysis document regarding IFRS 11, *Joint Arrangements* and disclosure for joint arrangements included in IFRS 12, *Disclosure of Interests in Other Entities* in July 2011, and believe that it constitutes a good starting point for undertaking the initiative.

Yet although 'effects analysis' is defined as a part of the IASB's standard setting process in its Due Process Handbook[1], the process is yet to be further substantiated in it. Clarification of terminologies and steps to take as set out in the DP will help address an expectation gap among stakeholders regarding what is meant by effects analysis. Therefore, while there are several instances where further considerations would be warranted (for example, we are not convinced that it is realistic or appropriate to 'consider' macro-economic factors. See our response to Q8), we generally support the proposed steps presented in the paper.

In addition, taking into account the accelerated trend towards the global convergence of accounting standards, we believe that it is not efficient for each national standard setter to replicate the steps that the IASB takes. Rather, we believe that the process would be more effective and efficient, if the IASB takes the leadership of the initiative, and national standard setters or regional groups partner with the IASB in proceeding with the steps. Such a partnership will be particularly helpful, when liaising with stakeholders on a national level

[1] IASB Due Process Handbook, *paragraph 109-110.*

(including regulators, user groups, and industry groups). We are pleased to provide the IASB with relevant assistance when undertaking the initiative.

Please see the Appendix for our comments to specific questions in the DP. If you have any questions, please feel free to contact us.

Yours faithfully,

Ikuo Nishikawa
Chairman, ASBJ

CC: Mr. Aki Fujinuma, Vice-Chair of the IFRS Foundation Trustees
Mr. Robert Glauber, Vice-Chair of the IFRS Foundation Trustees
Mr. Hans Hoogervorst, Chairman of the IASB
Mr. Masamichi Kono, Acting Chairman of the IFRS Foundation Monitoring Board

Appendix

Section 2: The process of '*effects analysis*'

Q1) Do you agree that 'effect analysis' should be defined, for the purposes of accounting standard setting, as a systematic process for considering the effects of accounting standards as those standards are developed and implemented (paragraph 2.2)?

If you disagree with the proposed definition, or would like it to be amended, please provide an alternative definition, and please explain why you favour that alternative definition.

We wonder if it would be possible to define 'effects analysis' more appropriately than a dictionary does. Rather, a focus should be given more on what is meant by 'effects analysis on developments of or revisions to financial reporting standards.'

In addition, we share the following observations on the proposed definition of 'effects analysis' (i.e., 'a systematic process for considering the effects of accounting standards as those standards are developed and implemented'):

- Effects analysis can be performed either in a systematic or ad-hoc manner, depending upon the surroundings;
- 'Consider' may be ambiguous; thus clarification should be sought;
- 'Effects' would be difficult to measure, and it may be very difficult, if not impossible, to capture actual effects before standards are implemented; and
- 'Effect' arises not only from the development of standards, but from the revisions to them.

Accordingly, we suggest that 'effects analysis on developments of or revisions to financial reporting standards' should be defined as follows (proposed additions are underlined, and proposed deletions are struck-out):

'a ~~systematic~~ process <u>to identify and evaluate</u> ~~for considering~~ the <u>anticipated or actual</u> effects <u>from the development of or revisions to financial reporting</u> ~~of accounting~~ standards as those standards are developed and implemented'

Q2) Do you agree that effects analysis should be integrated (or further embedded) into the standard setting due process (paragraph 2.7)? If not, why not? Please explain the reasons for your answer.

Yes, we agree that effects analysis should be integrated into the standard setting due process. As stated earlier, we believe that the IASB and national standard setters can effectively share the responsibility in the global standard setting environment.

Q3) Do you agree that the standard setter should be responsible for performing effects analysis, and that the performance of effects analysis by any other body is not a sufficient or satisfactory substitute (paragraph 2.11)? If not, why not? Please explain the reasons for your answer.

Yes, we generally agree that the standard setters should be responsible for performing effects analysis, since they should have the best knowledge about the proposed standards; thus, they should be best positioned to identify areas that are likely to be affected.

However, the process might become more objective if the third party committee plays a role of conducting effects analysis. Such a committee may consist of senior individuals who have profound knowledge and experience in financial markets (such as macro-economists, retired regulators, and academia). While accounting standard setters have profound expertise in accounting, effects analysis might require much broader expertise.

Q4) Do you agree that effects should be considered throughout the life-cycle of a project to introduce a new accounting standard or amendment, but that publication of a document setting out the key elements of the effects analysis should be specifically required, as a minimum, at the following points in time in that life-cycle (paragraph 2.15)?:

A. When an agenda proposal on the project is considered by the standard setter;
B. When a discussion paper is issued for public consultation (this effects analysis is an update to 'A', to reflect the latest information available;
C. When an exposure draft is issued for public consultation (this effects analysis is an update to 'B', to reflect the latest information available);
D. When a final standard or amendment is issued (this effects analysis is an update to 'C', to reflect the latest information available); and
E. For new accounting standards and major amendments, a 'post-implementation review' is required, which is an analysis of 'actual effects' that should be performed and published when the pronouncement has been applied for at least 2 years, together with the publication of an associated document setting out the key elements of the review; a post-implementation review is not required for minor amendments.

If you do not agree, why is this? Please explain the reasons for your answer.

Yes, we agree with the proposal. However, we suggest that the proposal be further clarified by stipulating that there is no need to mention effects in each and every agenda paper for board meetings, such that effects analysis may not hinder too much of the staff work before undertaking theoretical considerations. As stated in the cover letter, we are pleased to see the IASB's recent publication of effect analysis; however, we think that it would be more useful if such analysis is provided at respective standard-development stages (rather than at ex-post of standard publication only).

Q5) Do you agree that effects analysis should be undertaken for all new accounting standards or amendments, but that the depth of the analysis work should be proportionate to the scale of the effects (in terms of their 'likelihood of occurring and magnitude of the consequences' if they do occur), the sensitivity of the proposals and the time available (paragraph 2.19)? If not, why not? Please explain the reasons for your answer.

Yes, we generally agree with the proposal. As effects are inherently difficult to measure (thus, identifying immaterial projects is difficult), it is reasonable to presume that all new or revised standards should be scrutinised; while, the depth of the exercise should differ depending upon the nature of the projects.

For the purpose of determining the depth of the exercise, a judgmental framework should not be made too definitive or structured so as to ensure the practicality of the exercise. Rather, we suggest that standard setters should determine the extent of work to be performed, taking into account the relevant qualitative factors.

We believe that the 'likelihood of occurrence' and 'magnitude of consequences' are good qualitative indicators in evaluating the scale of the effects, but other factors should not be dismissed. For example, even if the development of or revision to a particular standard has a smaller magnitude of consequences, it may have a significant effect, when considered in aggregate with other regulatory or standard-setting developments. Therefore, other elements such as the impact on other standards or regulatory requirements should be factored into when determining the necessary level of analysis.

Section 3: The concept of '*effects*'

Q6) Do you agree that 'effect' should be defined, for the purposes of accounting standard setting, as consequences that flow, or are likely to flow, from an accounting standard, referenced against the objective of serving the public interest by contributing positively to delivering improved financial reporting (paragraph 3.2)?

If you disagree with the proposed definition, or would like it to be amended, please provide an alternative definition and please explain why you favour that alternative definition.

As stated in our response to Q1), we believe that 'effects analysis' should be defined in the context of developments of or revisions to financial reporting standards. In the same vein, we believe that 'effect' should also be defined in the context of developments of or revisions to financial reporting standards.

In addition, it may be possible that effects analysis is performed with reference to the objective of serving the public interest by contributing positively to delivering improved financial reporting, but we do not believe that analysis should be performed with such a narrower scope. Effects may be perceived differently among stakeholders, and standard setters will be asked to be sufficiently responsive when they receive inputs from stakeholders.

Therefore, we suggest that 'effects on developments of or revisions to financial reporting standards' be defined as follows (proposed additions are underlined, and proposed deletions are struck-out):
'*consequences that flow, or are likely to flow, from <u>developments or revisions to financial reporting</u> ~~an accounting~~ standard<u>s</u>~~, referenced against the objective of serving the public interest by contributing positively to delivering improved financial reporting~~*'

Q7) Do you agree that the term 'effects', rather than term 'costs and benefits' should be used to refer to consequences of standards, in order to distinguish effects analysis from a CBA, on the grounds that it would not be appropriate to require a CBA to be applied to standard setting (paragraph 3.7)? If not, why not? Please explain the reasons for your answer.

Yes, we agree with the use of the term 'effect' rather than 'costs and benefits,' since the term 'cost and benefits' predicates quantitative measurements of benefits and drawbacks. It is not usually possible or desirable to measure effects quantitatively, in the context of financial reporting standard setting.

Q8) Do you agree that the scope of the 'effect' to be considered, for the purposes of performing effects analysis, should include all effects, both ‘micro-economic effects’ and ‘macro-economic effects’ (paragraph 3.12)?

If you disagree, please provide an alternative way of specifying what the scope of ‘effects’ to be considered to be, and please explain why you favour that alternative.

Yes, we generally agree that the scope should include all effects, both ‘micro-economic’ and ‘macro-economic effects.’ However, some question if macro-economic effects should ever be neutral, given that the effects are measured in reference to the objectives of financial reporting. Moreover, we believe that the proposal should clarify that it is possible to *identify* whether significant macro-economic effects are likely to exist, but it would be significantly difficult to *consider* effects as proposed.

For instance, it might be predictable whether a proposed standard may give rise to some effects (whether they are positive, negative or encompass even pro-cyclical effects) on macro economy, but usually it is impracticable to consider or evaluate how the scale of the effects would be.

Q9) Do you agree that a standard setter can only be expected to respond to an effect which is outside of its remit (or for which an accounting standard is not the most effective means of addressing the particular effect) by communicating with the relevant regulator or government body to notify them of the relevant issue and to obtain confirmation from them that they will respond appropriately to it (paragraph 3.17)? If not, why not? Please explain the reasons for your answer.

Yes, we generally agree with the proposal. However, we believe that it is highly unlikely to be able to obtain confirmation from a relevant regulator or government body that they will respond appropriately to the effect, while it is possible for standard setters to notify them of the relevant issues. We recommend that the proposal acknowledge this regard explicitly.

Q10) Do you agree that ‘effects’ should be defined by reference to an objective, and that the objective should be that of serving the public interest by contributing positively to delivering improved financial reporting’, where ‘serving to the public interest’ means ‘taking into account the interests of investors, other participants in the world’s capital markets and other users of financial information’ (paragraph 3.19)?

If you disagree because you consider that ‘effects’ should not be defined by reference to an objective, please explain the reasons for your answer.

If you disagree because you consider that ‘effects’ should be defined by reference to an objective other than that specified above, please provide an alternative objective and please explain why you favour that alternative objective.

No, we disagree with the proposal to define effects referenced to an objective that is to serve the public interest by contributing positively to delivering improved financial reporting.

We believe that effects analysis involves communication with a wide range of stakeholders, and standard setters will not be able to control what should be communicated. In practice, stakeholders may communicate what they perceive as ‘effects’ with standard setters, and they would simply be requested to take a note of it.

While standard setters may try to ask specific questions or collate inputs in accordance with the proposed objective, it is unlikely that we can control everything. Therefore, we suggest that ‘effects’ should be defined without reference to particular objectives.

If the proposal (i.e., to define effects by reference to an objective) remains intact, we recommend that the term ‘public interest’ be articulated in greater detail. As a notion of public interest may be understood differently among stakeholders, we are concerned that the definition could confuse stakeholders without clear articulation.

Q11) Do you agree with the following clarifications of the term ‘effects’?

a) Effects can be ‘positive’, ‘negative’ or ‘neutral’, as determined by whether they support, frustrate or have no impact on the achievement of the objective of serving the public interest by contributing positively to delivering improved financial reporting (paragraph 3.23);

b) Effects analysis will usually involve assessing the ‘marginal effects’ of an accounting standard or amendment, relative to the status quo that existed before its introduction, so the term ‘effects’ should, in general, be interpreted to refer to ‘marginal effects’ (paragraph 3.24);

c) The term ‘effects’ can be used to refer to both ‘one-off effects’ and ‘ongoing effects’ (paragraph 3.26); and

d) The term ‘effects’ can be used to refer to both ‘anticipated effects’ and ‘actual effects’, depending on what stage the effects analysis is at - before, during or after implementation of the new accounting standard or amendment (paragraph 3.28).

If you do not agree with any of the above clarifications of the term ‘effects’, which one(s) do you disagree with and why? Please explain the reasons for your answer.

We generally agree with the proposal. However, in relation to the categorisation of effects as stated in a), we believe that effects can be clarified in five categories: ‘very positive,’ ‘positive,’ ‘neutral,’ ‘negative,’ and ‘very negative.’ Three levels of categorisation may seem too simple, which would not be adequate in achieving the objective of benchmarking exercise.

Q12) Do you agree with the following further considerations concerning effects:

a) Effects analysis should involve considering effects in terms of both their ‘incidence’ (who is affected) and their ‘nature’ (how they are affected), and that the standard setter should be transparent about whether and why they consider that the effects on one group should receive greater weight, less weight or equal weight to the effects on any other group (paragraph 3.30); and

b) Effects analysis should involve prioritising effects, possibly by ‘ranking’ them in terms of their ‘likelihood’ of occurring and the magnitude of the ‘consequences’ if they do occur (paragraph 3.32).

If you do not agree with any of the above further considerations concerning effects, which one(s) do you disagree with and why? Please explain the reasons for your answer.

We agree with the proposal set out in paragraph a), but ‘ranking’ effects as suggested in paragraph b) may be over-engineered. As the extent of effects is largely subject to judgment, and ‘likelihood’ and ‘magnitude’ can only work as factors for consideration, we propose not to proceed with ‘ranking’.

Section 4: The key principles underpinning effects analysis

Q13) Do you agree that there should be a set of key principles underpinning effects analysis (paragraph 4.2)? If not, why not? Please explain the reasons for your answer.

We think that ‘principle’ is not an appropriate term relative to the substances suggested: rather, they should be labelled as ‘key steps.’ Please refer to our response to Q14) for details.

Q14) Do you agree that the set of key principles underpinning effects analysis should be as follows (paragraph 4.2)?:

- Principle 1: Explain intended outcomes (refer to paragraph 4.2);
- Principle 2: Encourage input on anticipated effects (refer to paragraph 4.2);
- Principle 3: Gather evidence (refer to paragraph 4.2); and
- Principle 4: Consider effects throughout the due process (refer to paragraph 4.2).

If you disagree with the proposed set of key principles, or would like the principles to be amended, please provide an alternative set of key principles and please explain why you favour that alternative set.

We suggest setting out ‘a set of key steps’ rather than ‘a set of principles.’ A set of key steps that the IASB should take may be characterised as follows:

- Step-1: To formulate the entire plan of effects analysis.
- Step-2: To explain intended outcomes when agendas are set.
- Step-3: To encourage input on anticipated effects when due process documents are issued, by providing specific questions to stakeholders with assistance from national standard setters.
- Step-4: To document summary of inputs from stakeholders by collating evidence that has been received either directly or through national standard setters.
- Step-5: To publicise the document and submit it to the IFRS Foundation Trustees or its Due Process Oversight Committee for their review.
- Step-6: To seek to measure actual effects during the process of post-implementation reviews.

Section 5: The practicalities of performing effects analysis

Q15) Do you agree that the process that a standard setter should apply for validating the intended outcomes of a proposed accounting standard or amendments should include steps ‘a’ to ‘d’ of paragraph 5.2?

If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

We believe that it would be premature to formulate practical details as set out in this section, since an application to practice should be considered once a big picture is agreed.

Nevertheless, we suggest that the steps to take be aligned with the approach detailed in our response to Q14. Also, given the framework suggested in the DP, we share our comments to Q15-17 as follows.

We agree that the list of steps set out in paragraph 5.2 is a good starting point to consider the process for 'validating the intended outcomes of a proposed accounting standard or amendment.' However, we have the following observations.

- Subparagraph b) states that the standard setter should confirm that the net benefit of doing nothing is outweighed by the net benefit of issuing a new accounting standard or amendment. We consider that this is highly unrealistic, since accounting standard setters are not able to predict how the new accounting standard or amendment would be until the standards are finally approved. Since even changes in detailed wordings may significantly alter effects, standard setters cannot confirm the net benefit of issuing new standard or amendment.
- Subparagraph d) denotes that preparers, users, and other constituents can validate or propose the assumptions that the standard setters made. However, we believe that only standard setters are responsible for effects analysis. Therefore, the term 'validate' should be deleted to convey the intended message.

Q16) Do you agree that the process that a standard setter should apply for identifying and assessing the effects of a proposed accounting standard or amendment should include steps 'a' to 'f' of paragraph 5.3? If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

We generally feel comfortable with the proposal, but share the following observations:

- We generally agree with the subsection b), but effects should be categorised into five scales (Please see our response to Q11.)
- We do not believe 'ranking' the effects is necessary or relevant (Please see our response to Q12.)

Q17) Do you agree that the process that a standard setter should apply for identifying options for the proposed accounting standard or amendment (options for achieving the intended outcomes of the proposed accounting standard or amendment), and for choosing the preferred option, should include steps 'a' to 'f' of paragraph 5.4? If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

No, we do not believe that the process should include providing several options. We are afraid that providing and prioritising options may result in narrowing the scope of deliberations by the IASB, since stakeholders may think that there is no benefit of further deliberation if there is an objective prioritisation.

Additionally, providing options may be seen as giving too much emphasis on effects analysis. We believe that effects analysis is one of the critical elements in the standard setting due-process, but it is not a determinant factor of the entire process.

Therefore, we disagree that standard setters should identify options and choose preferred options as suggested in paragraph 5.4.

Q18) Do you agree that the IASB should, to some degree, delegate to national standard setters and similar institutions some of the activities involved in gathering evidence of the effects of accounting standards, particularly consultation with constituents, and that these bodies should play a more active part in the due process to ensure that IFRSs contribute positively to delivering improved financial reporting (paragraph 5.5)?

We generally agree with the gist of the proposal, but we consider that an improvement can be made with regard to how it is phrased. We believe that effects analysis should be performed as a process of international and national standard settings; however, we believe that the IASB should lead the initiatives, taking into account that standard setting processes are increasingly integrated globally and that most of the financial reporting standards are, in substance, agreed at the international level rather than at the domestic one.

Accordingly, we recommend that the proposal be clarified by stating that the IASB should lead the initiative by ‘partnering with’ national standard setters and regional groups (such as the AOSSG or EFRAG), rather than the IASB ‘delegate’ some of the activities to national standard setters.

Section 6: Next steps

Q19) Do you agree that the next steps in developing and, subject to the results of public consultation, implementing the proposals put forward in this paper should include steps ‘a’ and ‘b’ of paragraph 6.2?

If you disagree with the proposed next steps, or would like there to be additional next steps, please provide alternative and/ or additional steps and please explain why you consider that those alternative and/ or additional next steps are appropriate.

Although we highly appreciate the initiatives by the UK Accounting Standards Board and EFRAG to formulate the proposal, we believe that the IFRS Foundation Trustees should take a lead in considering the next steps. As stated earlier, we consider that effects analysis should be implemented, led by the IASB in collaboration with national standard setters or regional groups. Thus, we believe that the structure should ultimately be considered by the IFRS Foundation.

Further, we think that ‘field testing’ in paragraph 6.2 a) should be read ‘pilot testing,’ to clarify that the initiative is used as a part of initial assessment in determining whether the proposed framework is operational.