# The Discussion Paper

# "Conceptual Framework of Financial Accounting"

Accounting Standards Board of Japan
December 2006

(Tentative translation: 16 Mar. 2007)

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# Preface

## The Role of the Conceptual Framework

Conceptual frameworks, in general, organize the premises and concepts that underlie corporate accounting, particularly financial accounting. It offers a conceptual basis for accounting standards and, as a result, is expected to help provide a better understanding of these standards and enhance foreseeability in their interpretation. Moreover, conceptual frameworks, in general, aid users of financial statements and should have the effect of preventing unnecessary costs that those users might incur when attempting to interpret accounting standards.

Because it also has the role to provide guidelines for future standard setting, this Conceptual Framework is not merely a summary of existing fundamental premises and concepts, but also reflect an analysis and reexamination of those premises and concepts. Therefore, this Conceptual Framework includes parts that cannot explain some of the existing accounting standards and parts that have yet to become standards. However, this Conceptual Framework does not immediately propose developing or amending individual and specific accounting standards. Rather, its role is to provide basic guidelines.

## Environments Surrounding Accounting Standards

This Conceptual Framework builds on premises and concepts underlying existing accounting standards and reflects current constraints surrounding financial reporting. Constraints include market practices, investors' ability to analyze information, the current legal system and basic ideas underlying such system, and social value judgments regarding the economic impact of standard setting.

Today, these constraints are becoming common around the world, and the differences among countries are at least partly disappearing. This trend is particularly prominent in the business environment, where barriers to the cross-border transfers of goods, services, money and people have been removed and free trade based on common rules is successfully underway. As part of this trend, global convergence of accounting standards is under progress.

The ASBJ believes that the development of this Conceptual Framework, which establishes the fundamental concepts that underlie accounting standards and financial

reporting in Japan, would facilitate discussions in international settings aimed to achieve global convergence of accounting standards.

However, a concern may exist that releasing this Conceptual Framework as an Exposure Draft at this time may not be appropriate, considering the joint project between the IASB and the FASB, which is working towards developing a common conceptual framework. Thus, to avoid unnecessary confusion and misunderstanding, the ASBJ decided to release this Conceptual Framework as a Discussion Paper and not to seek public comments. In that sense, this Conceptual Framework presents the results of discussions at the ASBJ in recent years as part of its efforts to provide a conceptual basis for the various accounting standards in Japan.

The ASBJ believes that this Discussion Paper will further evolve through its participation in discussions in international settings, particularly the active participation in joint project between the IASB and the FASB to develop a common conceptual framework.

## This Conceptual Framework and Accounting Standards

Because this Conceptual Framework organizes the premises and concepts underlying accounting standards, its contents are abstract at best and, as a result, interpretation of the contents of this Conceptual Framework is necessary when developing or amending individual accounting standards. Thus, the specific contents of individual accounting standards cannot be determined from this Conceptual Framework.

Moreover, it should be noted that, given the ASBJ's central role, the purpose of financial reporting, as stated in Chapter 1 of this Discussion Paper, was prepared with the disclosure system of the securities market primarily in mind. Thus, this Conceptual Framework was developed for the information disclosure of the securities market, which applies mainly to public companies. Nevertheless, the ASBJ believes that the accounting standards developed based on this Conceptual Framework, which was developed for the information disclosure of the securities market, would be useful for the various users of financial statements.

## The Structure of this Conceptual Framework

While there are a variety of ways to structure a conceptual framework in general, this Conceptual Framework follows the structure of other conceptual frameworks that have

been developed by major accounting standard setting bodies outside Japan. This is because these frameworks are well known in Japan and the ASBJ believes that following their structure would facilitate the understanding of this Framework and is expected to function more effectively. In doing so, as noted above, the ASBJ believes that this Discussion Paper would facilitate communications with standard setting bodies outside Japan.

# Chapter 1 "Objectives of Financial Reporting"

## [Introduction]

Within the basic premises and concepts that support financial reporting, this Chapter focuses on describing the objective of financial reporting. The objectives of financial reporting are addressed as the first step in organizing basic concepts because, generally, the objectives of a social system determine its basic characteristics. The system of financial reporting is no exception.

No social system has universal objectives consistent over different times and different environments. The objectives of the financial reporting system are determined based on the needs of society and are not determined automatically. Accordingly, confirming the needs of today's society for this system should be the top priority when discussing how the system should be established.

Although financial reporting plays various roles, this Chapter considers the primary objective of financial reporting to be the disclosure of the financial situation of the entity which assists investors in predicting the performance of the entity and in estimating the value of the entity. Information regarding the position of the investments by the entity (stock) and the results of those investments (flows) is disclosed for those who predict the future and make investment decisions under their own responsibility.

Even though this Discussion Paper attaches great importance to the use of accounting information to estimate the value of the entity, other uses of accounting information must not be ignored. This Chapter also describes typical examples of secondary uses of accounting information and the relationship between these secondary uses and the development of accounting standards.

## [Main Text]

Objectives of the Disclosure System and Financial Reporting

1. In predicting the future of the entity, information pertaining to the current situation of the entity is essential. However, there is generally a large discrepancy between investors and management regarding the opportunity to obtain such information. Under these circumstances, if information is only insufficiently disclosed, investors would not be able to take the responsibility in estimating the value of stocks, bonds, or other securities issued by the entity and, thus, these securities would not be issued or traded easily. The raison d'etre of the disclosure system is to promote the disclosure of private information held by management in order to relieve such asymmetry of information and to resolve the malfunction of the market caused by such asymmetry.

2. Investors invest their funds in entities at their own will, with the expectation of obtaining uncertain future cash flows. When investors make decisions based on predictions of uncertain results, they need information regarding how the entity invests the funds and the results actually achieved from those investments. Management is basically required to disclose such information. The objective of financial reporting is to measure and disclose the position of the entity's investments[1] and the results of those investments as part of the disclosure system that assists investors in making decisions.

3. Among the information that financial reporting provides, profit information which represents the results of the entity's investments is basically the results of the past, but it is commonly used in predicting future cash flows, which provides the basis for estimating the value of the entity. Use of profit information implies emphasis on the information regarding stock of investments which generates profit. This is because not only the absolute amount of the results of the entity's investments but also the profitability (or efficiency) in comparison with the stock amount of investments which generates those results is considered to be important.

[1] The term "financial position" has been used as a term similar to "position of the entity's investments" used here. However, since the term "financial position" is used in various meanings, this Discussion Paper uses "position of the entity's investments" as a new term used at the abstract concept level.

Role of Accounting Standards

4. Management inherently has an incentive to voluntarily disclose the private information it possesses about the entity because the value of the entity may be unduly lowered by the conservative risk assessment of investors. Accordingly, information needed by investors would be voluntarily disclosed to some extent, even if there were no public regulation. Nevertheless, even in that case, minimum rules are necessary to eliminate false information as well as to ensure homogeneity of information, and it would be too costly to determine the rules through negotiations (contracts) between counterparties. In order to reduce such cost for the society as a whole, typical contracts are generalized and formed into accounting standards. Accounting standards are expected to function as a social norm supporting the disclosure system.

5. Whether accounting standards function effectively as minimum standards depend on whether the benefits from standardization or uniformity of contracts exceed the costs associated with them. Since costs and benefits depend on the environment, accounting standards may change corresponding to changes in environments.

Role of Each Key Player in the Disclosure System

6. There are three key players in the disclosure system: investors, who provide funds to entities using the information; management, who raise funds by disclosing information; and auditors, who enhance the reliability of the information through assurance engagements.

7. Investors in this context are those who invest in securities such as stocks and bonds traded in security markets and they include not only current holders but also potential holders of those securities. Investors use the disclosed information to estimate future performance of the entity and estimate the current value of the entity under their own responsibility. While some investors are superior in analyzing accounting information, other investors are not sufficiently capable of analyzing information and need the assistance of experts. However, the difference in the ability of processing information will not lead to advantages or disadvantages as long as securities markets are efficient. Accordingly, in principle, investors who possess the ability to analyze securities above a certain level should be considered when developing accounting standards.

8. Management is expected to disclose the necessary information so that investors can fulfill their role. Investors are responsible for predictions, and management is basically responsible for disclosing facts. Even when management is required to make predictions in the process of disclosing accounting information, the purpose of disclosing such predictions is basically to clarify the facts that have occurred up to present.

9. Auditors verify whether management is appropriately disclosing accounting information required by investors. Specifically, the role of the auditor is to audit whether the information is in compliance with generally accepted accounting standards, using generally accepted auditing standards. Auditors are responsible for auditing the information prepared by management and it is the management's responsibility to prepare the financial information.

10. These key players in the disclosure system all benefit from entities complying with accounting standards. Information prepared in compliance with accounting standards and audited by independent auditors is generally more relied upon by investors. Investors benefit from the fact that they can obtain such information at a low cost. If this leads to lower cost of capital required by investors and the value of the entity increases, management also benefits from accounting standards. Management also benefits from accounting standards because it reduces the costs to ascertain the information needs of investors individually. This is because accounting standards clarify the information to be provided in order to meet the minimum information needs of investors. Furthermore, auditors benefit from accounting standards because accounting standards provide auditors with the basis for judgment in the audit process.

<u>Secondary Uses of Accounting Information</u>

11. Accounting information provided under the disclosure system is used for secondary purposes, such as resolving conflicts of interests through private contracts between counterparties. In addition, accounting information is used in related laws and regulations that affect the general public. Typical examples include the limitations to dividends (under the Japanese Corporate Law), the tax filing system (under the Japanese Tax Code), and regulations for financial institutions (such as the capital adequacy regulation and the solvency margin regulation).

12. The achievement of the objective provided in paragraph 2 of this Chapter should be viewed as the highest priority in developing accounting standards. Nevertheless, the fact that accounting information is used for secondary purposes may become a constraint when developing or updating accounting standards. That is, the effects on the resolution of conflicts of interests through public regulations or private contracts should also be considered when developing or updating accounting standards. The objectives of financial reporting are achieved by also considering the relationships with the secondary uses of information.

## [Basis for Conclusions and Background Information]

### Objectives of the Disclosure System and Financial Reporting

13. Asymmetry of information causes problems not only in primary markets but also in secondary markets of securities. Unless future opportunity for sales is assured, investors will not be willing to purchase securities in primary markets in the first place. As far as entities are raising funds in securities markets, they must make continuous efforts to relieve the asymmetry of information in order to maintain smooth transactions of securities.

14. Accounting information that relieves asymmetry of information and accounting standards that determine the contents of the information are required even under an efficient market. Market efficiency is related to whether market participants correctly understand the information provided and to whether the market price promptly reflects the information. The issue of what should be disclosed, that is, the "contents of information," should be distinguished from efficiency. Even if rational market participants and efficient securities markets are presumed, the contents of accounting information to be disclosed must be determined through regulation by accounting standards.

15. Accounting information is prepared under technical and environmental constraints. Needs of investors are not fully satisfied solely by accounting information.

16. Accounting information is expected to assist investors in estimating the value of the entity, but accounting information in itself does not represent the value of the entity. It is the investors who invest at their own will that estimate the value of the entity, and accounting information is expected only to provide investors with the basis for forming predictions that are necessary in estimating the value of the entity.

### Function of Each Key Player in the Disclosure System

17. In today's securities markets, there are various information intermediaries who analyze information necessary for investments in securities on behalf of investors who are not sufficiently capable of analyzing information. By relying on these intermediaries, those investors can invest in securities while saving costs necessary to improve their own ability to analyze information. Assuming there is market competition among information intermediaries, accounting information will also be

efficiently communicated to investors who are not sufficiently capable of analyzing information. Since today's disclosure system is established on the premise of market efficiency, this Discussion Paper considers investors who are capable of analyzing above a certain level as the primary recipients of accounting information.

18. Contrary to the description of the roles of investors and management in paragraphs 7 and 8 of this Chapter, some expect management to disclose their estimates of the value of the entity based on the belief that management is superior in estimating the value of the entity because they have advantages in obtaining information related to specific businesses. However, disclosure of the value of the entity estimated by management leads to the issuers of the securities inducing investors to trade their securities by presenting their own judgment regarding the value of the securities. This not only is against the spirit of the Japanese securities exchange law system, but is also difficult for management to assume the responsibility for their judgment.[2] Thus, the objective of financial reporting is limited to the disclosure of facts.

19. Management has the incentive to disclose falsified information in order to maximize their profit (or the profit of the entity). However, investors have countermeasures to this possibility, such as lowering the prices of securities issued by the entity, dismissing management, or lowering compensation of management. In order to avoid such situations, reasonable management would willingly accept audits performed by independent auditors. That is, under the disclosure system, financial audit functions as part of a "bonding" scheme by which management restrains their own behavior so that investors will not suffer damages.

20. Financial audit is relied upon by society and functions effectively not only because of the auditors' professional ethics but also because of the complementary role of the mechanism that provides discipline to the relationship between management and auditors. Competition in the appointment of auditors as well as auditing standards that assure the quality of audits are presumed to restrain auditors from

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[2] Among factors that determine future cash flows of an entity, management has advantages in understanding entity-specific factors, since they possess unique insider information. However, management does not always have advantages in understanding factors related to the economy as a whole, such as business climates, interest rates and foreign exchange rates. Therefore, management is not necessarily superior to investors in estimating of the value of the entity from an overall perspective.

selfish behavior. That is, reliability in audits is enhanced by market disciplines including the bonding scheme for auditors themselves as well as the professional ethics required from auditors.

## Secondary Use of Accounting Information

21. Accounting information is also used for resolving conflicts of interests through public regulations and private contracts. Users of the financial information for secondary purposes appropriately modify the accounting information disclosed under the disclosure system based on the individual purposes of the regulations or the contracts. Accounting information is used for secondary purposes when it is less costly to prepare accounting information separately. In developing or updating accounting standards, consideration need not be given to all regulations and contracts. When regulations or contracts affect most constituencies, the effects of developing or updating accounting standards on the regulation or contract must be considered, but when contracts affect only a small number of constituencies, consideration need not be given in the same manner. This is because a balance must be considered between imposing costs of renegotiating contracts due to changes in accounting standards imposed on the majority of constituencies who are not involved in those contracts and the benefits associated with the changes.

## Chapter 2 "Qualitative Characteristics of Accounting Information"

### [Introduction]

This Chapter discusses the qualitative characteristics of accounting information that is required in achieving the objectives of financial reporting. The primary objective of financial reporting is to provide investors with information that is useful in predicting future cash flows so that investors can predict the performance of the entity and thereby estimate the value of the entity. The most significant characteristic required in accounting information is the usefulness in achieving the objectives of providing accounting information. This Conceptual Framework calls this characteristic "decision usefulness." It functions as a norm that is required by all accounting information and accounting standards that generate accounting information.

However, since this characteristic lacks concreteness and operability, it is insufficient to function as a guideline for developing standards in the future. The objective of this Chapter is to enable the norm of "decision usefulness" function by specifying and organizing lower-level characteristics that support "decision usefulness" and by describing the relationships among them. Accordingly, this Conceptual Framework does not only describe existing accounting standards and accounting practices inductively and summarizes them but it also reflects judgment regarding the usefulness and necessity in achieving the objectives of financial reporting.

The qualitative characteristics often bear the risk of being considered symbolic slogans and becoming the objectives of financial reporting themselves. In order to avoid such risk, when this Chapter was prepared, the characteristics discussed in conceptual frameworks issued overseas were considered. Based on the results, this Chapter pays special attention to the parallel, conflicting, or hierarchical relationship among characteristics, and the relationship between the characteristics and the objectives of financial reporting are always considered when the characteristics are described.

Nevertheless, the characteristics described in this Chapter do not consist of a system based on predetermined harmony nor are they mutually exclusive. In the context of developing accounting standards, a judgment regarding the extent to which each characteristic should be considered must be made individually under the given environmental circumstances based on the objectives of financial reporting. The objective of this Chapter is to define the characteristics and clarify the relationship

among them, not to provide guidance for such judgment.

## [Main Text]

Primary Characteristics of Accounting Information: Decision Usefulness

1. The primary objective of financial reporting is to disclose information that becomes the basis for evaluating the value of the entity, that is, to disclose the results of the operations of the entity and other related information that is useful for investors in predicting future cash flows. The most fundamental characteristic required for accounting information in achieving this primary objective is "decision usefulness." In other words, accounting information is expected to be useful for investors in predicting uncertain performance of the entity.

2. Decision usefulness is supported by two lower-level characteristics: the information is relevant to the decision made by investors (relevance to decision) and the information is reliable at a certain level (reliability). In addition, internal consistency and comparability provide a backbone to these three characteristics and function as a necessary condition or threshold.

Characteristics Supporting Decision Usefulness (1): Relevance to Decision

3. "Relevance to decision" means that accounting information contains information that is relevant to predicting future results of the investments by the entity and the accounting information positively affects and contributes to the investors' decision making through the process of estimating the value of the entity.

4. Whether accounting information contributes to the investors' decision making depends on, first of all, whether the accounting information has information value. The information is considered to have information value if obtaining the information improves the investors' predictions and behavior. Nevertheless, in the process of developing accounting standards, information value of accounting information provided by a new standard is often uncertain.[1] In such case, the investors' needs for information imply the existence of information value. Based on this implication, accounting standards are sometimes developed or updated to meet the needs of investors, even when the existence of information value is not so certain. In this sense, the existence of information value and the satisfaction of needs for

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[1] It is difficult to affirm whether specific information will improve investors' behavior in advance. This is because it is difficult to identify the investors' decision-making model and to specify the criterion for evaluation as to how the variety of expected outcomes should be evaluated by the society as a whole.

information are considered to be the two lower-level characteristics that support the characteristic of relevance to decision.

5. Nonetheless, not all accounting information supported by investors' needs for information is necessarily relevant to investors' decision making. Some information that is relevant to investors' decision making is provided from sources other than the disclosure system, and prudent consideration is required in determining whether the disclosure system should respond to all investors' needs for information. Thus, there are limitations to the role of satisfaction of needs for information in developing standards.

<u>Characteristics Supporting Decision Usefulness (2): Reliability</u>

6. Usefulness of accounting information is also supported by reliability. Reliability, which is supported by lower-level characteristics such as neutrality, verifiability, and representational faithfulness, means that accounting information is trustworthy.

7. (Neutrality) The interests of management, who prepare accounting information, are not necessarily aligned with those of investors. Therefore, it is difficult for investors to fully rely on the information prepared by management. In order to minimize adverse effects caused by the conflict of interests, accounting information must not be biased toward the interest of a particular constituency.

   (Verifiability) In measuring profits, estimates of future events are inevitable and the measurement based on estimates may vary significantly based on the person who makes the estimates. Such profit information inevitably contains some "noise," and it is difficult for investors to fully rely on information based exclusively on estimates. In order to avoid such situation, financial reporting should be based on facts unaffected by subjective judgment of the person who makes the measurement.

   (Representational faithfulness) When entities represent the facts into the form of accounting data, diverse facts must be classified into a small number of accounting categories. However, when criteria for such classification are left with room for interpretation, the result of the classification might not be trustworthy. In order to avoid this situation, there must be a clear corresponding relationship between the

facts and the accounting classification.[2]

Relationships among Characteristics

8. The two characteristics, relevance to decision and reliability, are sometimes fulfilled simultaneously but at other times there may be a trade-off between them.[3] Certain information may be desirable in one characteristic, but may be undesirable in other characteristic. When there is a trade-off between these characteristics, an overall judgment regarding the decision usefulness of accounting information that is expected under the new standard will be made taking both characteristics into account.

Characteristics as general constraints (1): Internal Consistency

9. Accounting standards that generate accounting information should be internally consistent so that accounting information is useful to users' decision making. Accounting standards constitute a single system supported by a small number of basic concepts and decision usefulness is a hypothetical goal of this system. Generally, an individual accounting standard is considered to have internal consistency if it is consistent with the basic concepts underlying accounting standards as a whole. If an individual accounting standard is internally insistent in such a manner, the usefulness of accounting information prepared in accordance with that standard can be inferred.

10. When developing individual accounting standards for new types of economic events or transactions, it should be judged in advance whether accounting information generated by the new accounting standards satisfies the qualitative characteristic of relevance to decision and reliability. Sometimes there is not enough empirical evidences that can be analogically applied to draw a conclusion. In such cases, judgment as to whether relevance to decision and reliability are satisfied is made through judging whether the accounting information (and the individual accounting standard which generates it) is internally consistent with the existing system of accounting standards. That is, internal consistency functions to enable indirect and complementary inference of relevance to decision and reliability of the

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[2] Reliability is not completely independent from relevance to decision. For example, as noted in the section discussing representational faithfulness, how facts are transformed into accounting data affects not only reliability but also the information value of accounting information.

[3] For example, in the case of estimated information in which measurement involves subjectivity, there may be a trade-off between relevance to decision and reliability.

accounting information. However, such inference process functions effectively only when there is a consensus that the existing system of accounting standards provides useful accounting information. When environmental conditions or paradigm of accounting theories have changed so that the consensus above is no longer considered to exist, relevance to decision and reliability cannot be inferred by internal consistency within the existing system of accounting standards.

Characteristics as general constraints (2): Comparability

11. Accounting information should be comparable so that it is useful to users' decision making. Comparability requires accounting information to be prepared so that it would not hinder comparison of different periods of the same entity or comparison of different entities at the same point of time. For this purpose, similar accounting treatments should be applied to similar facts (subjects) and different accounting treatments to different facts (subjects), so that users of accounting information can distinguish between the similarities and differences of the facts when comparing from period to period or comparing across entities.

12. To ensure comparability, the same accounting procedure should be applied continuously (consistently) within an entity, as well as using a uniform reporting format for financial statements. Moreover, disclosure of information that assist users in making comparisons is necessary. In addition, comparability should be considered when deciding transitional treatments for changes in accounting standards and when deciding the contents of note disclosures to call for attention. However, comparability does not necessarily call for criteria based on formalities or uniform accounting treatments. When information regarding differences in facts is necessary for users of accounting information for comparison and knowledge of the differences is useful to their decision making, different accounting treatments (procedures) would be necessary depending on those differences.

## [Basis for Conclusions and Background Information]

### Meaning of Qualitative Characteristics

13. There was a debate as to whether the purpose of preparing this Conceptual Framework should be to describe inductively how accounting standards have actually been developed or to discuss how standards should be developed and to clarify a norm that would function as guidance in the future. Because this Conceptual Framework is expected to serve as guidance for developing standards, it was decided that this Conceptual Framework not only describe facts but also include value judgments in order to fulfill this function.

### Lower-level Concepts to Reliability

14. With regard to neutrality, verifiability, and representational faithfulness, which conceptual frameworks issued outside Japan consider as lower-level characteristics that support reliability, there was a debate as to whether these terms should be redefined. One of the concerns was that these terms were used apart from their original meanings. However, it was also noted that these terms were already widely accepted in accounting practice and redefining them might lead to unnecessary confusion. Such consequence would contradict the expected role of this Conceptual Framework, which is to provide guidance for developing accounting standards in the future, as well as to present the basic attitude toward standard setting, that is, to respect internal consistency. In order to avoid these situations, this Conceptual Framework follows the existing conceptual frameworks issued outside Japan regarding the definitions of these characteristics.

15. In some cases, the availability of auditing techniques is discussed in connection with verifiability. However, accounting standards should be developed from the perspective of efficient achievement of the objectives of financial reporting and reduction of auditing costs cannot be a goal in itself.

### General Constraints

16. Relevance to decision and reliability function as criteria to directly assess whether accounting information is useful to users' decision making. On the other hand, internal consistency and comparability are the minimum basic conditions which are required for accounting information to be useful. These characteristics do not directly determine decision usefulness, but they are often used in indirect inference

of whether relevance to decision or reliability are satisfied. Therefore, these characteristics are considered as general constraints which support the hierarchy of qualitative characteristics as a whole, rather than within the hierarchy together with relevance to decision and reliability.

Internal Consistency

17. Accounting standards, as a whole, becomes a systematic structure when individual accounting standards are consistent with the basic concepts. In this context, the basic concepts refer to the collection of historical experience and accumulated knowledge regarding accounting standards, accounting practices, accounting researches, etc. The core of them are accounting theories, which their appropriateness is backed by experiences. Knowledge and experiences combined constitute the frame of reference for internal consistency. The important parts of that for standard setting activities are described in this Conceptual Framework. However, this Conceptual Framework does not provide all the details of the basic concepts, because some accumulated experience cannot be described. Accordingly, developing accounting standards in compliance with this Conceptual Framework is a necessary condition but not a sufficient condition in order to satisfy internal consistency.

18. Internal consistency works most effectively when there is consensus that the existing system of accounting standards provides useful accounting information. When that consensus no longer exists and a different system is considered necessary to prepare useful accounting information, the conceptual framework itself would need to be revised. Even in that case, once the new system of accounting standards is established, internal consistency functions under the new system. Unnecessary fixation to the existing accounting standards can fall into conservatism that refuses any reform and, therefore, a close eye should be kept on the continuation and changes in basic concepts supporting the usefulness of accounting information. The purpose of internal consistency is not to retain or continue customary practices.

19. As mentioned above, internal consistency is primarily related to accounting standards. However, accounting information aggregated based on more than one accounting standard can be meaningful only when it is generated by consistent accounting standards. Accordingly, this Conceptual Framework considers internal consistency as one of the qualitative characteristics of accounting information.

Internal consistency in this Conceptual Framework is different from the term "consistency." While the latter requires a particular accounting procedure to be applied (for interim reporting and annual reporting) every period continuously, the former requires that any individual standard adopted should be consistent with the existing system of standards.

<u>Comparability</u>

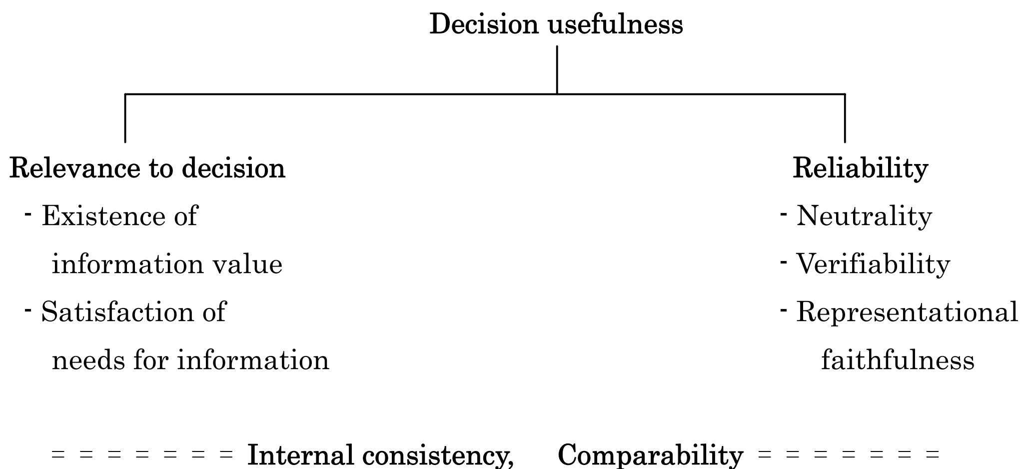
20. For accounting information to be comparable, the same accounting treatment should be applied when the substance is the same, that is, the amount, timing, and uncertainty of future cash flows of the entity is considered to be same from the viewpoint of investors' decision making, and different treatment should be applied when the substance is different. Comparability has been often discussed over two types of situations in which form and substance differ from each other. One is the case where two transactions (business activities) are different in legal forms but are the same in substance. In this case, the same treatment would be applied to the two transactions. This requirement has been called "substance over form" and comparability in this sense overlaps with representational faithfulness. The other is the case where two transactions (business activities) are the same in form and general attributes but are different in substance. For example, consider an entity that holds certain goods for sale and another entity that holds the same goods for its own use. In this case, different treatments should be applied to these two situations. By informing investors of the difference through accounting information, investors would be able to compare them appropriately. These two situations are collectively described as comparability, a characteristic that functions as a general constraint, because it is not necessarily clear whether the latter situation is covered by representational faithfulness.

21. Comparability of accounting information is considered to be an important characteristic internationally as well as in Japan. From this perspective, efforts of international convergence to reduce differences between accounting standards are necessary. However, comparability does not require uniform treatment based solely on formalities nor does it deny the use of different accounting procedures depending on the situation. To prepare accounting information which is useful to decision making, the substance of the business activities and transactions (business activities) should be taken into consideration. As a result, non-uniform treatments or reasonable discretion of the entity may be necessary in some instances.

Other Characteristics

22. Understandability, materiality, and consideration of costs and benefits, which are treated as general constraints and the like outside Japan, are not described in this Chapter as independent characteristics because they are self-evident and to keep the description of the system of qualitative characteristics concise. With regard to understandability, it was pointed out that it is self-evident if it represents the fact that human beings have limitations in their reasonableness. Moreover, with regard to materiality and consideration of costs and benefits, it was argued that they are also self-evident from the perspective of information value and economic reasonableness.

**<Relation Diagram of the Qualitative Characteristics of Accounting Information>**



# Chapter 3 "Elements of Financial Statements"

## [Introduction]

This Chapter clarifies the scope of financial reporting by identifying elements of financial statements and providing definitions of these elements. This Chapter is expected to function as guidance for determining whether a new economic event caused by an environmental change should be included in the scope of financial reporting. The role of this Chapter is to define elements of financial statements so that inappropriate items for the scope of financial reporting are eliminated and appropriate items are included. In providing the definitions, the judgment criterion is whether the inclusion of the item contributes to achieving the objectives of financial reporting. Financial statements are expected to play specific roles related to the objectives of financial reporting, and the items that become the elements of these statements are limited to those that assist these statements in playing their expected role.

Some elements are independent from other elements, while other elements are derived from those elements independently defined. This Chapter first provides independent definitions to assets and liabilities and, from these definitions, derives the definitions of net assets and comprehensive income. Moreover, considering the appropriateness to the investors' purpose of using information, this Chapter defines net income separately from comprehensive income and derives the definitions of revenues/gains and expenses/losses by relating them to net income. Assets and liabilities are defined first because to do so facilitates the determination and definition of the subjects of financial reporting. This is not based on comparison of usefulness as information nor is intended to derive any single particular measurement method.

The definitions of the elements of financial statements depend on other abstract concepts. Although technical accounting terms can be replaced with general terms, it is impossible to describe them without leaving any room for interpretation. Accordingly, in the process of developing standards, some interpretation is inevitable and interpreting the definitions of the elements literally itself does not determine the items to be included in financial reporting. An overall judgment is necessary in determining whether an item should be included in financial reporting, based on whether the item better achieves the objective of financial reporting by including such item.

## [Main Text]

### Role of Financial Statements and Their Elements

1. Under the current disclosure system, financial statements, such as the balance sheet, the income statement and the cash flow statement, are disclosed in order to achieve the objectives of financial reporting. These financial statements reflect the current position of investments made by the entity using funds provided by the owners of the entity as of a certain date and the results obtained from those investments during a certain period.[1]

2. In order to present the position and results of the entity's investments, this Conceptual Framework defines assets, liabilities, net assets, owners' equity, comprehensive income, net income, revenues/gains, and expenses/losses, as elements relating to the balance sheet and income statement.

### Constraints based on the Objectives of Financial Reporting

3. Since the roles of the balance sheet and the income statement are to disclose the position and the results of the entity's investments, the elements included in these statements are limited to those that fulfill their respective roles. Definitions of the elements are meaningful only if those elements assist in achieving the objectives of financial reporting and fulfill the role of respective financial statements. Items that do not fulfill these roles do not give rise to elements of financial statements, even if they meet the definitions.

### Assets

4. Assets are economic resources that the reporting entity controls as a result of past transactions or events.[2][3]

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[1] Elements related to the cash flow statement and other statements are not defined.

[2] Control represents a state in which the reporting entity has the capability to utilize the economic resources and obtain the benefits generated from them, regardless of whether the entity has legal ownership over them. Economic resources represent sources of benefits that contribute to obtaining cash. They are not limited to real goods, and include financial assets and their equivalents. Some economic resources have marketability and others do not.

[3] So-called deferred charges are not necessarily outside of the definition of assets, if future benefits from them can be expected. If the recognition of those items as assets is precluded, it is not because of the definition of assets but of the recognition or measurement criteria or constraints.

Liabilities

5. Liabilities are obligations or their equivalents to give up or deliver the economic resources that the reporting entity controls, as a result of past transactions or events.[4][5]

Net Assets

6. Net assets is the difference between total assets and total liabilities.

Owners' Equity

7. Owners' equity is a component of net assets attributable to shareholders who are the owners of the reporting entity (shareholders of the parent company in the case of consolidated financial statements).[6][7]

Comprehensive Income

8. Comprehensive income is the change in net assets during a certain period resulting from transactions or events other than direct transactions with shareholders, who are the owners of the reporting entity, minority shareholders of subsidiaries, and option holders, who may become its owners in the future.[8]

Net Income

9. Net income is a portion of the changes in net assets during a certain period (excluding changes resulting from direct transactions with shareholders, who are the owners of the reporting entity, minority shareholders of subsidiaries, and option holders, who may become its owners in the future) that represents the results of investments that are released from risks during a certain period and are attributable to the owners of the reporting entity. Net income gives rise solely to

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[4] Equivalents to obligations include those similar to legal obligations (such as constructive obligations).

[5] Under this Conceptual Framework, deferred revenues would be, in principle, classified as a component of net assets other than owners' equity.

[6] A component attributable to shareholders who are the owners of the reporting entity consists of a portion resulting from direct transactions with the owners of the reporting entity and a portion of the results of investments that are released from risks and attributed to the owners of the reporting entity.

[7] Owners' equity changes by direct transactions with shareholders or net income attributable to shareholders. Consequently, a component resulted from direct transactions with minority shareholders of subsidiaries or option holders are excluded from owners' equity.

[8] Typical examples of direct transactions are as follows: increases in the shareholders' equity of the parent company arising from stock issuance; minority interests of subsidiaries arising from consolidation procedures; issuance of warrants. For certain reclassification of items within net assets that do not arise from direct transactions as described above, the portion that is not a direct transaction may be included in comprehensive income.

changes in owners' equity.

10. The results of the investments by the entity ultimately are the net cash flows that represent the difference between the funds invested and the funds recovered. The basic constraint in the measurement of income is that the sum of income over the life of the entity must equal the sum of net cash flows over the life of the entity. This constraint holds for both comprehensive income and net income, but net income is different from comprehensive income in that it represents the results of investments that are released from risks. The results of the investments that are released from risks generally are determined based on whether a facts that can be compared with the expectations regarding the investment made by the entity has occurred.[9]

11. Net income is determined by deducting total expenses/losses from total revenues/gains and further adjusting for minority interests' share in earnings. Minority interests' share in earnings represents the results of investments released from risks during a certain period that is attributable to minority shareholders of the reporting entity's subsidiaries.

<u>Relationship between Comprehensive Income and Net Income</u>

12. Net income can be derived from comprehensive income by (1) deducting the portion of comprehensive income that is not released from risks, (2) adding a portion of other comprehensive income that was recognized in prior periods but released from risks of investments during the current period,[10] and (3) deducting minority interests' share in earnings.[11]

<u>Revenues/gains</u>

13. Revenues/gains are those items that result in increases in net income or minority interests' share in earnings, and represent the portion of the amount corresponding to increases in assets or decreases in liabilities having occurred by the end of a particular period which have been released from the risks[12]. Revenues/gains are

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[9] The contents of the expectations regarding the investments vary according to the substances of the investments. Accordingly, when to recognize the release from risks as the results of investments may vary according to the substances of the investments.

[10] Some refer to this process as recycling.

[11] The portion of comprehensive income described in paragraph 12(1), followed by the adjustment described in paragraph 12(2), is referred to as other comprehensive income.

[12] In many cases, revenues/gains accompany increases in assets or decreases in liabilities. Examples

accounting measures corresponding to cash flows resulted from the investment, which are outputs of the investment. The funds invested in inputs are exposed to the risks that future cash inflows are uncertain. By obtaining cash, risks of the investments dissolve entirely or decrease in proportion to the cash obtained. Cash generally refers to cash and its equivalents, but cash is deemed to have been obtained when it can be considered as such in substance, in determining whether the results of the investments have been released from risks. Revenues/gains are recognized when the funds invested are released from risks of the investments.

14. Increases in assets that give rise to revenues/gains take the form of occurrence of cash inflows as facts. Such cash inflows need to be allocated to periods as revenues/gains, based on the release from risks of the investments. For assets that are subject to constraints for business purposes, revenues/gains should not be recognized based on hypothetical disposal transactions and fictitious cash inflows.

Expenses/losses

15. Expenses/losses are those items that result in decreases in net income or minority interests' share in earnings, and represent the portion of the amount corresponding to decreases in assets or increases in liabilities having occurred by the end of a particular period which has been released from the risks[13]. Expenses/losses are accounting measures corresponding to inputs consumed (sacrificed) to obtain cash flows from the investments. Funds invested in inputs are released from the risk of investments by completing their role, when cash is obtained or it is determined that cash inflows will no longer be expected. Expenses/losses are recognized when the funds invested are released from the risks of the investments.

16. With regard to expenses/losses, great emphasis is placed on the relationship with cash outflows needed to acquire inputs. Such cash outflows need to be allocated to periods as expenses/losses, based on the release from risks of the investments.

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of revenues/gains that do not accompany increases in assets or deceases in liabilities include cases where revenues/gains are recognized when a transfer between items comprising net assets occurs (such as lapse of warrants, recycling of comprehensive income recognized in prior periods, etc.).

[13] In many cases, expenses/losses accompany decreases in assets or increases in liabilities. Examples of expenses/losses that do not accompany decreases in assets or increases in liabilities include cases where expenses/losses are recognized when a transfer between items comprising net assets occurs (such as recycling of comprehensive income recognized in prior periods, etc.).

## [Basis for Conclusions and Background Information]

<u>Constraints on Elements from the Objectives of Financial Reporting</u>

17. Paragraph 3 of this Chapter emphasizes that an item is included in the scope of financial reporting only when its inclusion contributes to achieving the objectives of financial reporting and fulfills the expected role of their respective financial statements. Although this is self-evident, it is deliberately emphasized because overemphasis on the definitions of elements might lead to a misleading argument that all items should be included in financial reporting whenever they meet the definitions, even if their inclusion might result in including items that are inappropriate for financial reporting.[14] It was argued that such a constraint regarding recognition, similarly to conceptual frameworks issued outside Japan. However, it was considered appropriate to describe such constraint in the discussion of elements, because this is an issue of what should be included in financial statements, not an issue of when to recognize or how to measure for items that could be included in financial statements.

<u>Net Assets and Owners' Equity</u>

18. This Chapter begins with providing the definition of assets and liabilities because it is expected to determine the definitions of elements easier and because it would be in line with global trends. Any credit on the balance sheet that does not meet the definition of liabilities is classified into net assets. Also, due to the significance of net income, this Chapter defines owners' equity as a portion of net assets as net stock of investments which generates net income. As a result, in this Chapter, a portion of net assets is not included in owners' equity.

19. As noted in the Chapter 1, "Objectives of Financial Reporting," information regarding profit that represents the results of investments is widely used for predicting future cash flows, which is the basis for assessing the value of the entity. It is the (current and future) owners of the entity who are interested in the value of the reporting entity that are the main users and the main beneficiaries of profit information. Based on this understanding, this Chapter defines owners' equity,

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[14] A typical example of an item that meets the definition in paragraph 4 but is not included in assets from the perspective of achieving the objectives of financial reporting is internally generated goodwill. Recognition of internally generated goodwill contradicts with the objectives of financial reporting, because it leads to self evaluation of the value of the entity by management (See paragraph 18 of the Chapter 1, "Objectives of Financial Reporting").

which corresponds to net income, as a portion of net assets attributable to the owners of the reporting entity. As described in the preceding paragraph, owners' equity represents the net stock of investments which generates net income.

20. Portions of net assets other than owners' equity include a portion resulting from direct transactions with minority shareholders of subsidiaries, a portion attributed to minority shareholders of subsidiaries within the results of investments released from risks, a portion resulting from direct transactions with option holders who may become owners in the future, and a portion that has not yet released from risks.

<u>Coexistence of Net Income and Comprehensive Income</u>

21. Although some argue that net income should be eliminated and replaced with comprehensive income, the position of this Conceptual Framework is that comprehensive income can not be a substitute for net income. That is because, based on the results of empirical researches up to present, the value of comprehensive income information does not exceed that of net income for investors. In contrast, net income information has been widely used by investors for a long time and empirical evidence supporting its usefulness has been confirmed. Therefore, it was decided that net income should continue to be positioned as a separate element of financial statements.

22. This Conceptual Framework positions comprehensive income as an independent element as well as net income because comprehensive income might be proved to be more useful than net income based on future research. Furthermore, as long as comprehensive income is disclosed as an item in addition to net income, it would not mislead investors. Therefore, it was decided that comprehensive income should be included in the system of elements of financial statements in order to be in line with global trends.

<u>Release from risks of investments</u>

23. This Conceptual Framework uses the term "released from risks of investments" when defining net income. Since risks of investments are uncertainty of the results of investments, the results of investments are released from risks when they become facts. What investors need is information as to how much results have been earned in comparison with the results expected at the time of the investment.

Definitions of Revenues/gains and Expenses/losses

24. As described in paragraphs 9 and 21 of this Chapter, this Conceptual Framework positively positions net income as one of the elements of financial statements and defines revenues/gains and expenses/losses, which are the sources of net income, by relating them to net income (and minority interests' share in earnings).

25. Some believe that components that increase net income should be classified into revenues and gains and components that decrease net income should be classified into expenses and losses. However, in this Conceptual Framework, the items that increase net income are called revenues/gains as a whole, and the items that decrease net income are called expenses/losses as a whole. This is because there is no fundamental difference between these components that would necessitate classifying them into independent elements.

## Chapter 4 "Recognition and Measurement in Financial Statements"

### [Introduction]

This Chapter describes when to recognize the elements that meet the definition in the Chapter 3, "Elements of Financial Statements" and how to measure them. This Chapter begins with describing the timing of recognizing the elements of financial statements that meet the definitions in financial statements (the triggers for recognition of the elements). Following that, this Chapter describes existing alternatives of measurement methods of each element recognized in the financial statements and the possible meanings of each measurement. Descriptions are classified largely into a part related to assets and liabilities and a part related to revenues/gains and expenses/losses.

In the part related to assets and liabilities, the meanings of the various measures are described, focusing on the relationship between each measurement and the entity's investment. In particular, for measures that directly represent the value of assets and liabilities, independent descriptions are provided regarding what circumstance of investment each measurement represents.

In the part related to revenues/gains and expenses/losses, the focus is mainly on: when the fund invested by the entity is released from risks of the investment; how revenues/gains that represent the results of the investments are recorded; and when and how expenses/losses that represent the sacrifices for obtaining those results are recorded. Such descriptions reflect the definition of net income as "results of investments that have been released from risks" in Chapter 3 "Elements of Financial Statements."

In addition to major methods currently adopted in practice, the recognition and measurement methods listed in this Chapter include those which might be used in the near future. This is because this Conceptual Framework is expected to provide guidance for standards setting in the future as well as to organize the basic concepts underlying existing accounting standards. In order to fulfill this mission, this Chapter also describes some recognition and measurement methods currently not adopted in Japan.

Conversely, this Chapter does not describe the recognition and measurement methods

which are currently adopted but in only highly limited situations. This is because providing meanings to those situations are not expected to function as guidance for standard setting activities in the future. Accordingly, this Chapter does not cover all possible methods of recognition and measurement.

When describing each method of recognition and measurement, this Chapter focuses on the relationship between the investments by the entity and their accounting measurements. That is, this Chapter addresses which recognition and measurement method can be applied to investments under which circumstances and the meaning of each measurement as a result of applying a certain method. This is because accounting figures need to be empirically related to the investment activities of the entity when investors predict future cash flows of the entity using accounting information. By describing this relationship, it is expected that, in the future, the appropriate recognition and measurement method would be chosen by clarifying the investment activity the new accounting standard is addressing.

In order to choose the appropriate recognition and measurement method, there must be a common understanding regarding the status or the essence of each investment. However, such understanding is left to consideration for the development phase of individual accounting standards.

## [Main Text]

### Definition of Recognition and Measurement

1. Recognition in financial statements represents recording elements on the face of the financial statements.

2. Measurement in financial statements represents assigning amounts in monetary units to items that are recorded in financial statements.

### Constraints on Recognition

[Triggers for Recognition]

3. Elements that meet the definitions in the Chapter 3, "Elements of Financial Statements," are recognized, in principle, when an underlying contract is executed by at least one of the counterparties. Furthermore, changes in the value of assets and liabilities once recognized could also be a trigger for recognizing a new element.

4. The first sentence of the preceding paragraph states that a bilateral agreement that is not executed by either party is not, in principle, recognized in financial statements. It is common belief that recognizing elements in connection with contracts that have uncertainties in execution bears the risk of providing misleading information. In order to avoid this situation, recognition of the elements have traditionally been deferred until the contract is at least partially executed.

5. However, some contracts regarding certain financial instruments have been recorded in financial statements before any of the parties have executed the contract. A typical example is a financial instrument for which the net difference between the settlement amount and its market price can be settled at the market at any time. For investments in these types of financial instruments, the change in net position itself is considered to be the result of investment released from risks, and the change may be recognized although the contract related to the change is not executed at all.

[Probability Required for Recognizing an Item]

6. In addition to the events described in paragraph 3 of this Chapter, a certain level of probability is required in order to recognize items that meet the definitions in the Chapter 3, "Elements of Financial Statements," in the financial statements. A

certain level of possibility (probability) means that a future event related to an element of financial statements is expected to occur with the likelihood above a certain level.

7. The condition described in the preceding paragraph is required when recognizing the elements of financial statements because recognizing elements with extremely low probability of occurrence would generate misleading information. On the other hand, it has been traditionally believed that accounting information based solely on facts that actually occurred is not useful to investors. When considering the probability of occurrence of an item, these two conflicting needs must be balanced.[1]

## Measurement of Assets

### 1) Historical Cost

[Definition]

8. Historical cost represents the amount of cash or cash equivalents paid in acquiring an asset, or the fair amount equivalent to the goods or services that was sacrificed to acquire the asset. This is sometimes called original acquisition cost when it is distinguished between depreciated (or unamortized) cost. Depreciated cost is the balance (or the residual amount) of an asset as a result of allocating a portion of the original acquisition cost to expenses/losses. Because depreciated cost is determined based on original acquisition cost, depreciated cost is categorized in the broad definition of historical cost.

[Meaning of Measurement]

9. Original acquisition cost is the amount of funds actually invested while depreciated cost is a portion of original acquisition cost that is not yet charged to income. Both original acquisition cost and depreciated cost assume that the present investment activity will be continued as it is. When assets are measured at depreciated cost, a portion of the invested funds is allocated to expenses/losses on a regular and systematic basis as sacrifices for obtaining the results of the investments.

10. Historical cost, particularly depreciated cost, represents the balance of the investment that is to be recovered in the future from the continued use of the asset.

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[1] The level of probability necessary for recognizing an item is not necessarily symmetrical between assets and liabilities. Some of this asymmetry has been traditionally called prudence or conservatism from a viewpoint other than providing useful information for investors' decision making and has been established in practice.

In other words, this measurement mainly functions as a means of measuring expenses/losses caused by the usage of the asset, rather than measuring the value of the asset. In the procedure of allocating expenses/losses over periods, estimates of several future events must be made, and when a significant error in the estimate becomes evident subsequently, the estimate must be properly adjusted and the depreciated cost be adjusted accordingly.[2]

### 2) Market Price

[Definition and Classification]

11. Market price represents a price quoted in a distribution market for a specific asset.[3] The markets that reporting entities face can be classified into those where the buyer's market and the seller's market is distinguished and those where they are not distinguished. What market price represents is different in these two cases. This Chapter distinguishes these two cases taking this into account.

### 2-a) Cases where the Buyer's Market and the Seller's Market Are Not Distinguished

[Meaning of Measurement]

12. The quoted market price in a market where the buyer's market and the seller's market are not distinguished is a typical indicator that represents the economic value of an asset. It represents either the amount of funds obtained through the disposal or liquidation of an asset, or the amount of funds necessary for repurchasing the asset (ignoring transaction costs). When it is presumed that existing business investment activities would continue, it is difficult to find an empirical meaning in this measurement for the assets utilized. However, for example, when an individual asset is disposed of, the information regarding the asset's quoted market price may be useful for investors.[4] In addition, the carrying amount of the asset sometimes becomes meaningless due to the events such as unexpected changes in the environment. In these cases, remeasurement using the quoted market price may be meaningful as a procedure for an extraordinary

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[2] In general, two different methods are used to account for adjusting estimates. One method is to fully reflect the changes in the related accounting figures in the period of adjustment. The other method is to reflect the changes in more than one period.

[3] In existing Japanese standards, the terms "market price" and "market value" are used differently. Market price has a narrower meaning and the term is used only when a market actually exists for the asset. Market value is used as a synonym for "fair value," which includes not only observable market prices but also estimated market prices.

[4] A typical example in which measurement using quoted market price is meaningful is trading securities.

adjustment of the carrying amount.

13. Changes in quoted market prices reflect the revisions of average expectations of market participants regarding future cash flows and discount rates. The change represents the results of investments for those that can be liquidated without any constraints from business activities and that are held with the expectation of favorable changes in market prices.[5]

14. As far as arms length transactions are presumed, the amount paid to acquire an asset are not considered to deviate significantly from the quoted market price of the asset at that time of acquisition. Unless a significant difference exists between the prices and unless the amount paid is not inferred to be deliberately manipulated, an asset is generally measured at the amount paid. However, if there is clear evidence to the contrary, the original acquisition cost may be determined using the quoted market price, regardless of the amount paid.

### 2-a) Cases where Buyer's Market and Seller's Market Are Distinguished

### 2-b-i) Replacement Cost

[Definition]

15. Replacement cost represents a price observed in a buyer's market (the market in which the entity participates when the asset is repurchased) where the buyer's market and the seller's market are distinguished.

[Meaning of Measurement]

16. Replacement cost represents the amount of funds required at the date of measurement to repurchase the asset the entity holds. Changes in replacement cost are often characterized as gains or losses that would arise if the acquisition of the asset were delayed. However, when the asset is continuously held and not actually repurchased, situations in which changes in replacement cost can be considered as the results of the investment are highly limited. Nevertheless, the carrying amount of an asset sometimes becomes meaningless due to events such as unexpected changes in the environment. In such case, remeasurement by replacement cost may be meaningful as a procedure for an extraordinary

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[5] To be more precise, in addition to changes in market price, cash flows arising in a form separated from the subject of the investments, such as interests received on interest-bearing bonds, are included in the results of investments. The same applies to replacement costs, net realizable value, and discounted value mentioned below.

adjustment of the carrying amount.

### 2-b-ii) Net Realizable Value

[Definition]

17. Net realizable value represents the amount calculated by deducting the estimated cost of selling (including after-sales service cost) from the price observed in a seller's market (the market in which the entity participates when it disposes of an asset) where the buyer's market and the seller's market are distinguished.

[Meaning of Measurement]

18. Net realizable value represents the amount of funds that can be recovered at the date of measurement when the entity disposes of an asset it holds. Changes in net realizable value are often characterized as (part of) gains or losses which would arise if the asset were disposed of at the end of the period. However, so long as the asset is continuously held and not actually disposed of, the situation in which changes in net realizable value is considered to be the results of investment is highly limited. Nevertheless, the carrying amount of an asset sometimes becomes meaningless due to the events such as unexpected changes in the environment. In these cases, remeasurement by net realizable value may become meaningful as a procedure for an extraordinary adjustment of the carrying amount.

## 3) Discounted Value

[Definition and Classification]

19. Discounted value is the measurement determined by discounting the estimated future cash flows to be obtained from the asset to the measurement date using a certain discount rate. When adopting this method, it is presumed that the timing of future cash flows can be estimated reasonably. Measurement by discounted value can be further classified into categories based on (1) whether estimates on future cash flows are continuously revised and (2) whether the discount rates are continuously revised.

## 3-a) Cases where Both Future Cash Flows and Discount Rates Are Continuously Revised

### 3-a-i) Value in Use

[Definition]

20. Value in use represents a measurement determined by estimating future cash flows

expected from the best use of the asset at the measurement date and discounting them using the discount rate as of the measurement date.[6]

[Meaning of Measurement]

21. Value in use and market price are typical indicators that represent the value of an asset. Value in use reflects the subjective value estimated by the reporting entity. It consists of the market price of an asset at the measurement date and the value of intangible goodwill related to the asset, where intangible goodwill is defined as the excess of value in use over the market value. Therefore, value in use is used when the value of the entity as a whole, including the value of intangibles not recognized on the balance sheet, is required to be estimated. Nonetheless, internally generated goodwill will be recognized when the asset is measured at value in use and the value exceeds historical cost.

22. When estimates regarding future events do not change, changes in value in use equals the normal return on the investment (the amount equivalent to the cost of capital). On the other hand, when estimates on future events change during the period, changes in value in use include not only the normal return on the investment but also the changes in expectations (so-called windfall) which is based on subjective estimates by management. As described in the Chapter 1, "Objectives of Financial Reporting," the objective of financial reporting is to disclose facts or results. Measurement by value in use is meaningful only in limited cases where subjective estimates can be the only surrogate for facts.[7]

**3-a-ii) Discounted Value Used to Estimate Market Price (Fair Value)**

[Definition]

23. Discounted value used to estimate market price represents a measurement determined by estimating cash flows assessed by average market participants and discounting them using the discount rate assessed by average market participants at the measurement date. This measurement provides a positive meaning as a surrogate for market price when measuring the value of the asset at the measurement date when a market price does not exist. See paragraphs 12-14 regarding measurements using market price.

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[6] There are several alternative discount rates that can be used and considered to be appropriate.

[7] For example, the carrying amount of an asset is reduced to its recoverable amount when the asset loses its profitability and full recovery of the carrying amount of an asset becomes unlikely.

### 3-b) Cases where Only Future Cash Flows Are Continuously Revised

[Definition]

24. Discounted value where only future cash flows are continuously revised represents an accounting measurement determined by estimating future cash flows from the use of an asset at each measurement date and discounting them by the fixed discount rate used when the asset was acquired.[8]

[Meaning of Measurement]

25. For future cash flows that arise from the asset, this measurement reflects only the changes pertaining to recoverability. The measurement cannot be considered to represent the value of the asset as of the measurement date because it does not fully reflect collection risk and neglects the risks intrinsic to discount rates. However, this measurement is sometimes used to recognize the two components in the changes in value as results of investments. One component is the interest income determined by using the fixed discount rate called the original effective rate. The other component is gains or losses arising from changes in estimates of future cash flows. Under this measurement, all the changes in recoverable amounts discounted by the initial discount rate are considered to be gains or losses when the estimates are adjusted.

### 4) Amount to Be Collected (Settlement Amount or Receivable Amount in the Future)

[Definition]

26. The amount to be collected represents the amount calculated by simply (without discounting) summing up future cash flows expected from the asset. Generally, it refers to the recoverable amount related to the contractual principal of the receivables.

[Meaning of Measurement]

27. This measurement represents the amount to be received in the future or the estimated collectible amount. When allowances for uncollectible receivables are recorded, they are deducted from the carrying amount of the related receivables.

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[8] For receivables, the prevailing practice is to determine a specific discount rate (initial effective rate) which would equate the discounted future cash flows to be collected in the future with the original acquisition cost, and increase the carrying amount every period for the interest equivalent. The carrying amount, called the carrying amount using the interest method, is a typical example of discounted value described in paragraph 24.

The changes in this measurement reflect the changes in the credit standing of the debtor.

### 5) Amount based on Net Assets of an Investee

[Definition]

28. The amount based on net assets of an investee represents the amount corresponding to the interest of the investor in the net assets of the investee.[9]

[Meaning of Measurement]

29. This measurement represents the reporting entity's interest in the investee, or the investment amount. It is mainly used in measuring the profit based on changes in net assets of the investee,[10] but it may also be used when other measurements do not represent the current status of the investment. For example, the carrying amount of an asset sometimes becomes meaningless due to events such as unexpected changes in the environment. In these cases, this measurement may be meaningful in an extraordinary adjustment of the carrying amount.[11]

## Measurement of Liabilities

### 1) Amount to Be Paid (Settlement Amount or Payable Amount in the Future)

[Definition]

30. The "amount to be paid" represents the amount calculated by simply (without discounting) summing up future cash flows required for repaying the liability. Generally, it represents the amount of repayment related to the contractual principal of the payables.

[Meaning of Measurement]

31. The "amount to be paid" represents the amount which must be paid in the future. When the amount to be paid is fixed by contracts or other arrangements, no expenses/losses other than interest expenses are recognized until the time ofrepayment.[12] On the other hand, when the amount to be paid is based on

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[9] This measurement includes the so-called "value of the investment using the equity method." However, some use this term to include unamortized goodwill, and others use this term to exclude unamortized goodwill.

[10] Paragraph 47 of this Chapter describes the measurement of revenues/gains focusing on the results of the investee's activities.

[11] For example, this measurement is used for the devaluation of unlisted stocks.

[12] However, when a liability is forgiven, a gain on forgiveness of a liability, which equals the difference between the amount payable under the contract and the actual amount payable, is recognized.

estimates, all the changes in estimates are recorded in net income for the period.

**2) Amount of Cash Received**

[Definition]

32. The "amount of cash received" represents the amount of cash or cash equivalents received in return for an obligation to provide goods or services. When services are provided based on the passage of time, the amount of cash received is allocated over periods systematically and regularly and the carrying amount of the liability is reduced accordingly. The balance of a liability as the result of the allocation is called an unsettled or unexpired balance. Because the unsettled and the unexpired balance are determined based on the amount of cash received, the unsettled and the unexpired balance are categorized as part of the broad definition of amount of cash received.

[Meaning of Measurement]

33. The "amount of cash received" represents the amount of funds actually received. When a financial liability is measured by the amount of cash received, the difference between the amount of cash received and the sum of the payments regarding the liability (both principal and interest) is characterized as interest expenses or gains or losses on redemption. On the other hand, when a nonfinancial liability is measured by the amount of cash received, the carrying amount of the liability is reduced based on the fulfillment of the obligation to provide goods or services, and the corresponding amount is recognized as revenue. As a result, the liability is measured by the unsettled balance or the unexpired balance.

**3) Discounted Value**

34. See paragraph 19 of this Chapter for the definition of discounted value, the meaning of adopting discounted value, and the classification of discounted value.

**3-a) Cases Where Both Future Cash Flows and Discount Rates are Continuously Revised**

**3-a-i) Discounted Value Using the Risk-free Rate**

[Definition]

35. Discounted value using the risk-free rate represents a measurement determined by

estimating future cash outflows[13] at the date of measurement and discounting them using the risk-free rate at the measurement date.

[Meaning of Measurement]

36. The discounted value using the risk-free rate represents the value of a liability estimated by the reporting entity as a debtor, ignoring the reporting entity's default risk. Changes in this measurement are affected by changes in expected cash outflows, passage of time, and changes in the risk-free rate, but are not affected by the changes in the credit standing of the reporting entity.

#### 3-a-ii) Discounted Value Using Risk-adjusted Discount Rate

[Definition]

37. Discounted value using risk-adjusted discount rate represents a measurement determined by estimating future cash outflows at the measurement date and discounting them using the discount rate adjusted by the credit risk of the reporting entity at the measurement date.

[Meaning of Measurement by Discounted Value Using Risk-adjusted Discount Rate]

38. This measurement may be meaningful in estimating the market price of the liability. Changes in this measurement reflect changes in the credit standing of the reporting entity as well as changes in estimated cash outflows, passage of time, and changes in the risk-free rate. However, so long as the contractual obligation of the reporting entity has not changed, these changes are not considered to be results of the investments. For example, if the reporting entity cannot settle the liability because it is constrained from business investments even though the liability is funding a profitable investment, changes in the discounted value using risk-adjusted discount rate should not be recognized as gains.

#### 3-b) Cases where Only Future Cash Outflows Are Continuously Revised

[Definition]

39. Discounted value where continuous revisions are made only in future cash flows represents a measurement determined by estimating future cash outflows at each measurement date and discounting them by the fixed discount rate used when the liability was initially incurred.

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[13] Cash outflows mentioned in paragraphs 35-41 of this Chapter include the repayment of the principal of the liability and the payment of interest.

[Meaning of Measurement]

40. Changes in this measurement can be classified into two components. One component is interest expense calculated by the fixed discount rate used when the liability was initially incurred. The other component is gains or losses arising from the changes in estimates on future cash outflows. Changes in this measurement include adjustments to the amount to be repaid discounted by the initial discount rate.

**3-c) No Revisions to Future Cash Flows nor Discount Rate**

[Definition]

41. Discounted value with no revisions to future cash flows nor discount rates represents a measurement determined by discounting future cash outflows estimated when the liability was initially incurred by the discount rate used when the liability was initially incurred.

[Meaning of Measurement]

42. Changes in this measurement represent interest expense based on the beginning balance of the liability (the balance at the date of incurrence for liabilities incurred during the period) determined using the initial effective interest rate.

**4) Market Price**

43. See paragraphs 11 and 12 of this Chapter for the definition of market price and the meaning of this measurement.

<u>Measurement of Revenues/Gains</u>

**1) Measurement of Revenues/Gains Focusing on Exchange Transactions**

44. Measurement of revenues/gains focusing on exchange transactions represents a method of recording revenues/gains in which revenues/gains are measured by the consideration obtained in exchange for delivering goods or services to a third party. The criterion for recording revenues/gains is whether the results of investments have been released from investment risks. For business investments, whether the results of investments have been released from risks is generally determined based on whether assets that are not subject to business risks have been obtained in exchange for assets that are subject to business risks. The amount of revenues/gains in this case depends on the measurement of the consideration

received. That is, revenues/gains are measured by the increases in assets when the consideration results in increases in assets or the decreases in liabilities when the consideration results in decreases in liabilities. Revenues/gains are measured based on the measurements of these assets or liabilities.

**2) Measurement of Revenues/Gains Focusing on Changes in Market Prices**

45. Measurement of revenues/gains focusing on changes in market prices represents a method of recording revenues/gains in which revenues/gains are measured by favorable changes in market prices of assets or liabilities held by the reporting entity. Assets or liabilities that can be liquidated (or settled) at any time and the opportunity to liquidate (or settle) them is not restricted by business activities are considered to be recovered (settled) and reinvested (refinanced) repeatedly, expecting favorable results from liquidation (settlement). In those cases, changes in market prices are considered to give rise to the results of investments. The amount of revenues/gains is measured by the increases in market prices during the period.

**3) Measurement of Revenues/Gains Focusing on Partial Execution of Contracts**

46. Measurement of revenues/gains focusing on partial execution of contracts represents a method of recording revenues/gains based on partial execution of contracts when there are contracts to continuously provide goods or services. In those contracts, a portion of the contract amount related to the partial execution is considered to be the result of investments when the reporting entity partially executed the contract (before the counterparty's execution), if it is certain that the counterparty will execute the contract (pay the consideration) in return for the goods or services provided.[14] The amount of revenues/gains is measured by multiplying the contract amount by the portion executed during the period.[15]

**4) Measurement of Revenues/Gains Focusing on the Results of the Investee's Activities**

47. Measurement of revenues/gains focusing on the results of the investee's activities represents a method of recording revenues/gains in which revenues/gains are

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[14] Similarly, if the reporting entity received the contract amount upfront and it is certain that the reporting entity would execute the contract, a partial execution of the contract (before the contract is completely executed) gives rise to results of investments for the portion the reporting entity executed the contract.

[15] For example, in the case of loans, the contract is considered to be executed partially based on the passage of time.

measured by the increase in the investment account caused by the results of investments earned by the investee. When the investee is considered to be integrated with the investor, business activities of the investee are considered to be an extension of the business activities of the investor. In those cases, the investor's results can be determined by focusing on the results obtained by the investee. In this case, the amount of revenues/gains is measured by multiplying net income of the investee by the investor's interest in the investee.

## Measurement of Expenses/Losses

### 1) Measurement of Expenses/Losses Focusing on Exchange Transactions

48. Measurement of expenses/losses focusing on exchange transactions represents a method of recording expenses/losses in which expenses/losses are measured by the consideration sacrificed in exchange for goods or services to a third party. See paragraph 44 of this Chapter for this measurement method.

### 2) Measurement of Expenses/Losses Focusing on Changes in Market Prices

49. Measurement of expenses/losses focusing on changes in market prices represents a method of recording expenses/losses in which expenses/losses are measured by unfavorable changes in market prices of assets or liabilities held by the entity. See paragraph 45 of this Chapter for this measurement method.

### 3) Measurement of Expenses/losses Focusing on Partial Execution of a Contract

50. Measurement of expenses/losses focusing on partial execution of contracts represents a method of recording expenses/losses in which expenses/losses are measured based on partial execution of contracts, when there are contracts to continuously be provided with goods or services. See paragraph 46 of this Chapter for this measurement method.

### 4) Measurement of Expenses/Losses Focusing on the Fact of Usage

51. Measurement of expenses/losses focusing on the fact of usage represents a method of recording expenses/losses in which expenses/losses are measured by the consumption of assets or the depletion of the values of assets caused by actual usage. This method is generally applied to assets that are subject to constraints under business activities. In this case, expenses/losses are recorded based on the decrease in the measurement of the assets (for those assets consumed at the time of acquisition of goods and services, their original acquisition costs). Costs caused by

the consumption of goods or services may be capitalized as deferred expenses/losses, if they meet the definition of assets as well as the criterion for recognition and measurement.

52. When it is difficult to identify the quantitative decrease in the value of an asset caused by usage, cost allocation traditionally has been considered to be the appropriate method for measuring the monetary decrease in the value of an asset. Cost allocation represents a process of systematically allocating the original acquisition cost of an asset over a certain period following a predetermined scheme. When expenses/losses are measured through systematic allocation, some future events must be estimated in advance. When a significant error in the estimates becomes evident subsequently, adjustments to the allocation scheme may be required in conjunction with changes in estimates. Revenues/gains or expenses/losses may be reported depending on the method of adjustment adopted.

## [Basis for Conclusions and Background Information]

### Selection of Measurement Methods

53. This Chapter describes various measurement methods for both assets and liabilities. This Chapter does not consider market price and value in use as measurement methods to be used with higher priority in all cases. In other words, original acquisition cost and depreciated cost are not considered negatively in the sense that the use of these measurement methods should be permitted only when it is difficult to obtain measurements using methods such as market price, but are positively positioned with equal prominence to other measurement methods. This is because various measurement methods are required in order to achieve the objective of financial reporting. Applying a uniform measurement method, such as historical cost or fair value, to all assets and liabilities itself does not assist in achieving the objectives of financial reporting.

54. Some measurements can be interpreted to be related to more than one measurement method. For example, when a fixed interest loan is measured at loan origination, the measurement of this loan can be interpreted as historical cost, discounted value, or the amount to be collected. Since these measurement methods do not necessarily conflict with each other and are not mutually exclusive, this Chapter leaves room for interpretation and does not deny relating measurements to more than one measurement method.

55. Some items that meet the definition of assets or liabilities are measured at the amount that does not have a stand-alone meaning as a measurement of assets or liabilities. As in the case of receivables that are recognized under the percentage of completion method and accrued retirement benefits recognized based on the employee services that were consumed in the past, there are cases where measurement of assets or liabilities are determined as a result of determining the results of investments.

### Meaning of "Release from Risks"

56. Chapter 3, "Elements of Financial Statements," defines net income as the results of investments released from risks. Accordingly, this Chapter pays attention to whether the results are released from investment risks when the meanings of certain measurements and the results of investments measured by those changes

are described.

57. As described in paragraph 23 of the Chapter 3, the results of investments being released from risks means that the results expected at the time of the investment have become definite as facts. In particular, for business investments, their results are considered to be released from risks when independent assets that are not subject to business risks are considered to be obtained in exchange for assets subject to business risks.[16] Needless to say, this Conceptual Paper leaves room for interpretation on what event should be considered to have obtained individual assets. Interpretations in specific cases will later be determined based on consensus in the process of developing and updating standards. In contrast, changes in the value of financial investments which are not constrained by business purposes and held in expectation of capital appreciation are results that can be compared with the ex-ante expectations and fall under the results of the investments released from risks.

58. The notion of "realized" or "realizable" is similar to the notion of "release from risks of investments." Although there may be different interpretations to the term "realized results," in the narrowest sense it is usually characterized as the results supported by the fact of sales or results supported by the fact that nonmonetary assets are converted into monetary assets. "Realized results" in this sense are considered to be "results released from risks of investments" in this Conceptual Framework. However, release from risks of investments is not determined solely by the so-called convertibility nor the disposability of the assets obtained. "Realizable results" are often considered to be the results that are (or have become) readily convertible to cash or cash equivalents. "Realizable results" in this sense are not always "results released from risks of investments."[17] Considering that the term "realization" is used in many meanings and none of those meanings cannot explain the recognition of net income, revenues/gains and expenses/losses related to investments of various substances in its entirety, this Conceptual Framework uses

[16] When revenues/gains are recognized in exchange transactions between dissimilar assets, the results of investments are considered to be released from risks when assets that are not subject to the same business risks before the exchange are obtained.

[17] For example, investments in subsidiaries or associate and available-for-sale securities which are listed in stock markets are readily convertible to cash or its equivalents and therefore the changes in their market prices could be interpreted as "realizable results". However, since disposals of those securities are constrained by business purposes, changes in the market price of those securities are not considered to be "results released from risks."

the term “release from risks of the investments" to explain them comprehensively.