

Convergent Evolution in
Accounting Conceptual Framework:
Barker and Penman (2016) and ASBJ (2006)

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Balance Sheet Approach in Retreat

- Under the ongoing IASB Conceptual Framework, recognition and measurement in accounting are heavily dependent on the balance sheet approach in which income is just a periodical change of net assets, though the IASB has somewhat backtracked recently admitting the *practical* importance of profit or loss, i.e., traditional earnings.
- Richard Barker and Stephen Penman (2016) proposed an alternative “mixed” approach (BP2016 hereafter).

“New” Alternative Approach I

Taking into consideration the implications of uncertainty, the balance-sheet approach cannot be executed satisfactorily if the income statement is implicitly treated simply as a by-product. As the Framework recognizes, the income statement and the balance sheet are structurally linked, so consideration of the income statement is important in implementing the balance sheet approach.

“New” Alternative Approach II

The balance sheet approach is thus implemented with respect to the consequences in the income statement. The labels, “balance-sheet approach” and “income statement approach” are in some sense distracting, but one might call our approach a mixed balance sheet and income statement approach. Or an approach that focuses on the income statement, but with the implementation of matching (under uncertainty) done from the balance sheet.

West Inadvertently Meets East

- In 2006 ASBJ already advocated in its Conceptual Framework (hereafter ASBJ2006) for an approach similar to that of BP2016, although the two distinguished western scholars did not mention the accounting framework from the Far East.
- Prof. Shizuki Saito and I wrote this short paper and sent to Prof. Penman. He kindly acknowledges it in the final version (2017) and Penman (2016).

Uncertainty at the Center of ASBJ2006

- Its key concept, *release from risks of investments* (投資のリスクからの解放), is equivalent to uncertainty resolution in BP2016.

Accounting information is expected to be useful for investors in predicting uncertain performance of the entity.

会計情報には、投資家が企業の不確実な成果を予測するのに有用であることが期待されている。

Released from Risks of Investments

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.

日本語原文

この概念フレームワークでは、純利益を定義する上で、「投資のリスクから解放された」という表現を用いている。投資のリスクとは、投資の成果の不確定性であるから、成果が事実となれば、それはリスクから解放されることになる。投資家が求めているのは、投資にあたって期待された成果に対して、どれだけ実際の成果が得られたのかについての情報である。

Matching at the Center of BP2016

- BP2016 practically equates uncertainty resolution with matching in recognition, while ASBJ2006 is conspicuously silent on matching.
- Matching is a key concept if we want to construct a flow-centered system of accounting recognition.
- The central concept is uncertainty resolution or release from risks, and matching is an important but subsidiary one.
- In most cases, recognition based on matching corresponds to an accounting expression of uncertainty resolution, it does not exhaust all cases.

Types of Matching

- BP2016 proposes an exhaustive classification that distinguishes four different levels of matching (Types 1 through 4)
 - In the final version, Type 5 is added for OCI , but abstracted away in this presentation.

Types 1 & 2: Revenue & *Ex Ante*

Type 1 – revenue matching – refers to expenses that can be described as ‘directly recoverable’... The defining feature of Type 1 is a direct relationship between revenue that is earned and expense that is incurred.

Type 2 – *ex ante* matching – refers to expenses that can be matched, *ex ante*, to periods of time... The defining feature of Type 2 is that the period over which expenses are incurred is known with a reasonable degree of certainty.

Type 3: *Ex Post*

Type 3 – *ex post* matching – refers to expenses (and also income) that can be matched to any given reporting period, yet where the matching can only be evidence-based *ex post*...the defining feature is that year-end market prices (and hence reported gains or losses) can be known at the end of the reporting period but not at the beginning.

Type 4: Mismatching

Type 4 – mismatching – refers to expenses that cannot be matched, either *ex ante* or *ex post*, to either revenue or accounting period...because of underlying uncertainty concerning the recoverability of the outflow of economic resources, there is no basis on which an evidence-based amortization scheme could be established, either *ex ante* or *ex post*.

Does Type 3 Belong to Matching?

- Types 1 and 2 are typical and innocuous subcategories of matching.
- Type 4 is the case of immediate expensing due to non-existence of matching.
- However, Type 3 does not belong to matching. Claiming it does sounds a category mistake.

No Need for Matching Concept

- The change of the market price should be considered the realization of cashflow if assets are held for trading.
- We do not need the matching concept for income recognition for the putative case of Type 3.
 - The fact that uncertainty is resolved at the end of each period is sufficient for recognition.
- This case shows that uncertainty resolution rather than matching is the criterion of income recognition although matching is involved in most cases of resolution.

Viewpoint of ASBJ2006

- Investment results are released from risks when their uncertainty is resolved or substantially reduced.
- Accounting information is expected to measure the determined results as timely as possible and help investors revise their ex ante expectation and make future investment decisions appropriately.

Operational/Financial Dichotomy

- The determined results or facts are those of cashflow because investment is an exchange of current certain cashflow for future uncertain one.
- There are two types of investment activities, operational and financial(事業／金融投資).
- Japanese conceptual framework tries to capture the nature of two investment activities through income recognition based on the concept of release from risks.

When Released from Risks? Financial

- Financial investment, not identical with investment in financial securities, is the type of investment with which the company seeks for gains through arm's length transactions unconstrained by any business considerations.
- There is no uncertainty to be resolved in the sense that the company can realize a gain or loss at any time. Because any change of the price itself is a realized result of investment, it should be recognized as income in accounting measurement.

When Released from Risks? Operational

- Uncertainty of operational investment is not resolved until cashflow from the operational activities is realized.
- The change of the market value should not be reflected on income except in the case of divestiture or impairment because the company intends to make a profit through not the sales of the investment, but revenues it generates.

Matching Expenses

- The release from risks concept is applied to recognition of not only revenues but also expenses.
- The outflow and depreciation of assets are recognized as expenses when they are released from risks in the sense that it is reasonable to assume that they no longer generate revenues, i.e., their expected role vanishes either favorably or unfavorably.
- Recognition of expenses explicated here is traditionally called matching and corresponds to Types 1 and 2 of BP2016.

Matching under ASBJ2006

- As for operational investment, matching is an inevitable consequence when the idea of release from risks or uncertainty resolution is applied to income recognition. Therefore ASBJ does not explicitly mention matching in the process of income recognition.
- As for financial investment, matching is not considered a necessary procedure to recognize income because the release from risks concept is directly applicable to the change of the market price.

Matching under BP2016

- BP2016 is most likely to intend to simultaneously determine recognition of income and assets through matching as the necessary and sufficient condition.
- In BP2016, balance sheet valuation and income measurement are two sides of the same coin. Therefore they have to construct the ex post matching concept , which seems to be a category mistake, in recognizing the market price change of financial investment as income.

Delinked under ASBJ2006

Also, due to the significance of net income, [ASBJ] defines owners' equity as a portion of net assets as net stock of investments which generates net income. As a result... a portion of net assets is not included in owners' equity.

純利益を重視して、これを生み出す投資の正味ストックとしての株主資本を、純資産の内訳として定義している。その結果、純資産には株主資本に属さない部分が含まれることになる。

- The decoupling of income and asset recognition is a surprisingly old idea, widely discussed in the German-speaking world in the early 20th century (Kovero 1912) .

Therefore...

- There is no need of simultaneous determination of balance sheet valuation and income measurement through matching or any other concept because balance sheet valuation and income recognition are conceptually delinked.
- Traditional net income is explicitly given primacy over comprehensive income. The former is not linked with the change of net assets through the clean surplus relation, while the latter is.
- The change of asset value is a necessary but not sufficient condition for net income recognition.

Clean Surplus Maintained

- While the clean surplus of income and shareholders' equity is maintained, the change of net assets includes cases of asset reevaluation not released from risks and consequently not recognized as income.
- Other net assets – net assets minus shareholders' equity – functions as a mezzanine or buffer account with which we can recognize the change of asset value in the balance sheet, and at the same time recognize income only when the investment is released from risks.

After All, ASBJ2006 Is a Pioneer

- BP2016 and ASBJ2006 reach the essentially same practical conclusion in income recognition through their respective “mixed” approaches despite different procedural perspectives on income recognition in the case of financial investment.
- The fact that such distinguished scholars have independently come to the conclusion similar to ASBJ2006 is encouraging for the Japanese scholars and practitioners who try to make accounting information theoretically sound and practically useful.

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