The Series of Discussion Papers

"Conceptual Framework of Financial Accounting"

Working Group on Fundamental Concepts

September 2004

(Tentative translation: 28 Feb. 2005)

Contents

Issuance of the Series of Discussion Papers
"Conceptual Framework of Financial Accounting"

Background Information on the Issuance of the Series of Discussion Papers "Conceptual Framework of Financial Accounting"

Based on remarks received from various constituencies regarding the necessity for developing a written conceptual framework as a basis for developing accounting standards in Japan, the Accounting Standards Board of Japan (hereinafter called "the Board") organized a Working Group under its supervision, which mainly consists of external academics, and delegated the study of this issue to the Working Group. Some full-time Board members and some staff also participated in the Working Group, and the Working Group held as many as 46 meetings under the guidance of the Chairman. This series of Discussion Papers "Conceptual Framework of Financial Accounting" (hereinafter called "these Discussion Papers") summarizes the conclusions reached by the Working Group.

Consequently, the views provided in these Discussion Papers are not necessarily those of the Board but are those of the Working Group that were reported to the Board. These Discussion Papers may eventually become accepted as de facto standards if their usefulness is confirmed in the process of developing standards in the future and if improvements are made to reflect the opinions of constituencies. The Working Group expects the Board to continue discussing these Discussion Papers with constituencies as necessary while observing how these Discussion Papers are accepted.

Although there are various possible alternatives regarding the structure of the conceptual framework, the structure of these Discussion Papers is basically in line with precedent conceptual frameworks issued overseas. Since conceptual frameworks issued by major accounting standard setters overseas are well known in Japan, using the same structure would facilitate the constituencies' understanding of these Discussion Papers and enable these Discussion Papers to function more efficiently. In addition, adopting the same structure would also facilitate communication with standard setters overseas regarding international convergence (or international harmonization) of accounting standards.

Role of the Discussion Papers

These Discussion Papers summarize and organize the basic premises and concepts underlying existing business accounting (financial accounting in particular) and their contents are expected to provide guidance for developing accounting standards in the future. If the guidance provides systematic stability to accounting standards, predictability regarding changes in accounting standards would be enhanced. Assisting constituencies in preparing for the uncertain future and avoiding unnecessary costs through enhanced predictability is another important role expected from these Discussion Papers.

Summarizing and organizing basic premises and concepts facilitates communications with standard setters overseas. When international convergence (or international harmonization) of accounting standards is pursued, explanations of the causes of the differences are often required. These Discussion Papers are also expected to provide an effective basis for these explanations.

These Discussion Papers are not only expected to organize existing accounting standards systematically as possible, but also to provide guidance for developing accounting standards in the future. Therefore, the contents of these Discussion Papers do not necessarily explain all existing accounting standards and may explain what has not been reflected in existing standards. Nevertheless, these Discussion Papers are not proposing immediate developments or updates of specific accounting standards. The role of these Discussion Papers lies in providing basic guidance through the organization of basic concepts.

Environments Surrounding Accounting Standards

Since these Discussion Papers summarize the premises and concepts underlying existing accounting standards in a systematical manner, they are affected by the current constraints surrounding financial reporting. These constraints include common practices in markets, investors' ability to analyze information, basic concepts that underlie the legal system, and the social value judgments pertaining to the economic impact of developing standards.

Today these constraints are becoming homogeneous worldwide and the differences among jurisdictions are at least partially eliminated. This tendency is particularly noticeable in the constraints in business environments. Barriers to international transfers of goods, services, money, human resources, and so on are disappearing and free trades under common rules are becoming prominent. Along with these trends, efforts are made for international harmonization or international convergence in accounting standards.

Nonetheless, differences in the constraints attributable to differences in the initial conditions based on history or geographical location have not been fully eliminated yet. Accounting standards are affected by those constraints that remain different. The basic concepts summarized in these Discussion Papers are based on these constraints and, therefore, the concepts summarized in these Discussion Papers do not necessarily possess the universality to be adopted beyond the differences in the constraints. The contents of these Discussion Papers may be different from similar conceptual frameworks issued overseas that are subject to different initial conditions. In addition, the contents of these Discussion Papers may change together as surrounding environments change. That is, changes in constraints may cause related changes in accounting standards, which may eventually cause changes in basic concepts.

Limitations of these Discussion Papers

Since these Discussion Papers summarize and organize the premises and concepts underlying existing accounting standards, they inevitably contain abstract descriptions. The contents of these Discussion Papers must be interpreted when individual standards are developed or updated. Accordingly, any specific content of an individual standard cannot be directly deducted from the contents of these Discussion Papers.

Furthermore, it should be noted that the objectives of financial reporting that are summarized and organized in these Discussion Papers are basically described with the disclosure system of the Japanese Securities Exchange Law in mind, in connection with the primary role of the Board. Disclosures by public companies in security markets are presumed in these Discussion Papers.

Discussion Paper "Objectives of Financial Reporting"

[Introduction]

Within the basic premises and concepts that support financial reporting, this Discussion Paper focuses particularly on the objective of financial reporting and attempts to form a consensus among Working Group members. The objectives of financial reporting are addressed as the first step in organizing and summarizing 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 Discussion Paper 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 takes the position that accounting information is primarily used to estimate the value of the entity, other uses of accounting information must not be neglected when discussing what financial reporting should provide. This Discussion Paper also attempts to form a consensus among Working Group members regarding how accounting information might be used for secondary purposes and how these secondary uses should be addressed in the context of developing accounting standards.

[Main Text]

<u>Objectives of the Disclosure System and Financial Reporting</u>

1. In predicting future cash flows generated by the entity, information pertaining to the situation the entity faces 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 the 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 information pertaining to the position of the entity's investments and the results of those investments.[1] The objective of financial reporting is to measure and disclose such information 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 particularly important. Profit 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. Emphasis on profit information implies emphasis on the information regarding net 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 amount of investments which generates those results is considered to be important.

<u>Role of Accounting Standards</u>

4. Management inherently has an incentive to voluntarily disclose the private

[1] The importance of disclosing of cash flow statements is becoming increasingly prominent.

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 intervene between the two and provide assurance to the information.

7. Investors include not only current holders of securities such as stocks and bonds but also participants in securities markets and creditors as well. 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 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 at 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 only 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.

Secondary Uses of Accounting Information

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 Commercial Code), 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 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]

<u>Objectives of the Disclosure System and Financial Reporting</u>

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.

<u>Function of Each Key Player in the Disclosure System</u>

17. In today's securities markets, there are various information intermediaries who analyze information necessary for investments in securities on behalf of unsophisticated investors (that is, those who do not have sufficient ability to analyze information). By relying on such intermediaries, unsophisticated 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 unsophisticated investors. Since today's disclosure system is established on the premise of market efficiency, this Discussion Paper considers investors who have the ability to analyze above a certain level (that is, sophisticated investors) as the primary recipients of accounting information.

18. Contrary to the description of the roles of investors and management in paragraphs 7 and 8, 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, 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 may deliberately choose to disclose false 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 has the incentives to 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 selfish behavior. That is, reliability in audits is enhanced by market disciplines

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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. This is the reason why, the estimation of the value of the entity based on future cash flows is not be delegated to management.

including the bonding scheme for auditors themselves as well as the professional ethics required from auditors.

21. Accounting standards should be determined based on whether the objectives of financial reporting can be achieved efficiently. In the process of determining accounting standards, a set of available auditing techniques is considered as an important constraint. However, auditing techniques are merely a constraint for achieving the objectives. Developing accounting standards that reduce auditing costs is not in itself a goal to achieve.

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

22. 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.

Discussion Paper “Qualitative Characteristics of Accounting Information”

[Introduction]

This Discussion Paper 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 Discussion Paper 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 Discussion Paper is to enable the characteristic of “decision usefulness” function by specifying and organizing lower-level characteristics that support “decision usefulness” and by describing the relationships among them. Accordingly, this Discussion Paper 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 addressed in this Discussion Paper 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 Discussion Paper was prepared, the characteristics discussed in conceptual frameworks issued overseas were considered in the context of history and geographical area. Based on the results, this Discussion Paper 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 Discussion Paper 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 and how to balance characteristics when there is a trade-off between them must be made individually under the given environmental circumstances based on the objectives of financial reporting. The objective of this Discussion Paper is to define the characteristics and clarify the relationship among them, not to provide guidance for such judgment.

[Main Text]

<u>Primary Characteristics of Accounting Information: Decision Usefulness</u>

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. Usefulness of accounting information for investors' decision making is supported by the following characteristics: to be relevant to the decision made by investors (relevance to decision); to be prepared in accordance with an internally consistent set of accounting standards (internal consistency); and to be reliable at a certain level (reliability).

<u>Characteristics Supporting Usefulness (1): Relevance to Decision</u>

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 in advance whether specific information will improve investors' behavior. 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 in the role "relevance to decision" can play in developing standards.

Characteristics Supporting Usefulness (2): Internal Consistency

6. In addition to "relevance to decision," usefulness of accounting information is supported by internal consistency of accounting standards that generate accounting information. Accounting information is considered to have internal consistency if it is generated based on rules consistent with the basic way of thinking underlying accounting standards as a whole. Accounting standards constitute a single system supported by a small number of basic concepts, and the fact that the standards have been actually used and are established in practice suggests that useful information has been provided under such system. In the absence of evidence to the contrary, relying on standards that are consistent with the system is considered as a qualitative characteristic required for useful accounting information.

7. Internal consistency is particularly important as a judgment criterion when developing new accounting standards for new types of economic events or transactions, as long as environmental conditions have not changed dramatically. If environmental conditions have not changed, it can be inferred that accounting standards consistent with the current system of accounting standards should provide useful information. In that case, attention only needs to be paid so that the new standard is not inconsistent with existing related standards. Developing standards in this manner can be more efficient than developing standards by estimating the value of accounting information individually because clues in determining accounting standards are provided.[2]

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[2]Maintaining internal consistency can also be useful when predicting changes in accounting standards. For example, preparers and users would be able to adapt their behaviors to the new environment little by little if how accounting standards would change can be predicted in response to new types of transactions.

8. On the other hand, when the environment surrounding financial reporting changes, it would become meaningless to pursue consistency with accounting standards that are appropriate for the old environmental conditions. Developing standards focusing on internal consistency is meaningful only when the environment does not change and a specific accounting treatment is concerned. When the environment changes, a new system of accounting standards appropriate for the new environment should be sought after by referring to the investors' needs for information.

Characteristics Supporting Usefulness (3): Reliability

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

10. (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.

Relationships among Characteristics

11. The three characteristics: relevance to decision, internal consistency, and reliability,

are sometimes fulfilled simultaneously and other times there may be trade-offs among the characteristics. Certain information may be desirable in one characteristic, but may be undesirable in other characteristics. 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 all characteristics into account.

[Basis for Conclusions and Background Information]

Meaning of Qualitative Characteristics

12. There was a debate as to whether the purpose of preparing this Discussion Paper 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 series of Discussion Papers is expected to serve as guidance for developing standards, the Working Group decided not only to describe facts but also to provide value judgment so that this function is fulfilled.

Internal Consistency

13. The most significant difference between this Discussion Paper and conceptual frameworks issued overseas is that, in addition to relevance to decision and reliability, this Discussion Paper considers internal consistency of rules that generate information as a characteristic supporting decision usefulness of accounting information. Because the number of cases where information value or needs for information can be directly confirmed is limited, it is difficult to describe the characteristics required in useful accounting information by referring only to relevance to decision and reliability. If the information value of the new accounting standard is uncertain, accounting information supported by consistent rules can play a complementary role in estimating information value that supports relevance to decision. For this reason, this Discussion Paper provides independent presence to the characteristic of internal consistency.

14. As described in paragraph 6, the basic way of thinking underlying existing accounting standards is important as the benchmark for considering consistency when developing or updating a standard. In this context, the basic way of thinking represents the collection of historical experience and accumulated knowledge regarding accounting standards, accounting practices, accounting researches, etc. . Although important parts related to developing accounting standards are described in this Discussion Paper, it does not describe all of them. Accordingly, developing accounting standards in compliance with this Discussion Paper is a necessary condition but not a sufficient condition in order to achieve internal consistency. The limitations to this Discussion Paper should be sufficiently noted.

15. Apart from the jurisdictions of common laws such as the United States and the United Kingdom, Japan is a country of code laws. In jurisdictions of code laws, respect for internal consistency of accounting standards is strongly required in order to achieve stable order. Generally, under code laws, the relationship between a new rule and existing rules must always be considered when developing or updating rules. Unfortunately, there is little understanding about this fact globally. By clarifying the needs for emphasis on internal consistency and the limitations to focusing on internal consistency, it is expected to assist in the mutual understanding of how standards are developed globally.

16. Internal consistency in this Discussion Paper is different from the term "consistency" that is referred to in conceptual frameworks issued overseas. 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>Relationship among Characteristics</u>

17. When preparing this Discussion Paper, there was a debate as to whether the three characteristics: relevance to decision, internal consistency, and reliability, should be presented equally or to consider a new higher-level characteristic that is placed above relevance to decision and internal consistency and present equally this new characteristic with reliability. This Discussion Paper acknowledges the unique significance of internal consistency and presents it equally with relevance to decision.

18. There was also a debate as to whether the three characteristics should be presented equally or if reliability should be considered higher in the hierarchy than the other two characteristics that functions as a constraint. If reliability were independent from the other characteristics and it always took precedence over the others, reliability should be considered to function as a constraint over the other two characteristics. However, reliability is not fully independent from relevance to decision.[3] In addition, the Working Group believed that the top priority should be given to decision usefulness and there exists no superiority or inferiority among the

[3] For example, as noted in the section discussing representational faithfulness as a part of reliability (paragraphs 9 and 10), how facts are transformed into accounting data affects not only reliability but also the information value of accounting information.

three lower-level characteristics. Therefore, reliability and the other characteristics are presented equally in this Discussion Paper.

Subordinate Concepts to Reliability

19. With regard to neutrality, verifiability, and representational faithfulness, which conceptual frameworks issued overseas 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 the terms were used apart from their original meanings. However, it was also noted that those 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 series of Discussion Papers, which is to provide guidance for developing accounting standards in the future, as well as the basic attitude toward standard setting, that is, to respect internal consistency. In order to avoid these situations, this Discussion Paper follows the existing conceptual frameworks issued overseas regarding the definitions of these characteristics.

General Constraints

20. There was a debate as to whether comparability, understandability, materiality, and consideration of costs and benefits should be included in the qualitative characteristics of accounting information. The Working Group confirmed the basic policy that qualitative characteristics should be described briefly and decided that characteristics which are self-evident, overlapping with other characteristics, or doubtful about their significance should not be included.

21. Much time was spent on the debate regarding comparability. It was argued that representational faithfulness is originally a characteristic that requires “different treatment to different facts, similar treatment to similar facts” and if uniform treatment were to be required for different facts by bundling them together with the intention of unduly narrowing the room for discretion by management, that might do harm to the decision usefulness of accounting information for investors. In other words, a concern was expressed regarding the uniformity of accounting treatments. Furthermore, it was argued that if representational faithfulness is defined in the way described above, comparability can be considered as a part of representational faithfulness. Based on these arguments, this Discussion Paper does not refer to comparability.

22. With regard to understandability, it was pointed out that considering understandability as a qualitative characteristic might contradict with the assumption of sophisticated investors. It was also pointed out that taking understandability into consideration would be self-evident if it represented the fact that human beings have limitations in their reasonableness. Furthermore, it was pointed that it was not clear as to how understandability, as a qualitative characteristic, would function as guidance for developing standards in the future. With regard to materiality and consideration of costs and benefits, it was argued that they are self-evident from the viewpoint of economic reasonableness. Based on these discussions, this Discussion Paper does not refer to understandability, materiality, or consideration of costs and benefits.

<Relation Diagram of the Qualitative Characteristics of Accounting Information>

Decision usefulness

Relevance to decision
- Existence of information value
- Satisfaction of needs for information

Internal consistency

Reliability
- Neutrality
- Verifiability
- Representational faithfulness

Discussion Paper "Elements of Financial Statements"

[INTRODUCTION]

This Discussion Paper clarifies the scope of financial reporting by identifying elements of financial statements and providing definitions of these elements. This Discussion Paper 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 objective of this Discussion Paper 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 criterion is whether the inclusion of the item contributes to achieving the objectives of financial reporting. The two primary financial statements, the balance sheet and the income statement, 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 Discussion Paper first provides independent definitions to assets and liabilities and, from these definitions, derives the definitions of net assets and comprehensive income. Further, considering the incomparable usefulness of profit information, this Discussion Paper defines net income independent from comprehensive income and derives the definitions of revenues/gains and expenses/losses by relating them to net income. Thus, there is no hierarchical relationship between comprehensive income and net income in their definitions. Assets and liabilities are defined first because it is easier to determine the scope of financial reporting, not because they are considered with higher significance than other elements. It should be noted that this does not lead to a uniform measurement method for assets and liabilities.

The definitions of the elements of financial statements depend on other abstract concepts (such as entity, economic resources, and control). 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, two primary financial statements, the balance sheet and the income statement, are disclosed in order to achieve the objectives of financial reporting. They reflect the current position of investments made by the entity using funds provided by the owners of the entity at 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, three elements called assets, liabilities, and net assets are disclosed on the balance sheet and three other elements called revenues/gains, expenses/losses, and net income are disclosed on the income statement. Another element called comprehensive income is sometimes disclosed in addition to these elements. This Discussion Paper provides definitions to these seven elements (assets, liabilities, net assets, revenues/gains, expenses/losses, net income, and comprehensive income).

General Constraints on Elements

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 or their equivalents that the reporting entity controls as a result of past transactions or events.[2]

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[1] A cash flow statement serves a complementary role to the information provided by the balance sheet and the income statement, but are excluded from consideration in this Discussion Paper because it does not have elements equivalent to those of the balance sheet and the income statement.

[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 ownership over them. Economic resources represent a set of benefits that contribute to obtaining cash. Some economic resources have marketability and others do not. Equivalents to economic resources typically represent economic resources that the reporting entity may control in the future.

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.[3]

Net Assets

6. Net assets is the difference between total assets and total liabilities. It consists of owners' equity, which is attributable to shareholders who are the owners of the reporting entity (shareholders of the parent company in the case of consolidated financial statements), and other components of net assets. Other components of net assets include portions attributable to parties other than owners of the reporting entity and portions not attributable to any party.

7. The portion of other components of net assets attributable to those other than the owners of the reporting entity includes minority interests.[4] On the other hand, the portion of other components of net assets not attributable to any party includes the results of investments that have not been released from risks.

Comprehensive Income

8. Comprehensive income is the change in net assets during a certain period caused by transactions or events other than direct transactions with shareholders, who are the owners of the reporting entity, minority shareholders of subsidiaries, and optionees, who may become its owners in the future.[5]

Net Income

9. Net income is a portion of the changes in net assets during a certain period (excluding changes caused by direct transactions with shareholders, who are the owners of the reporting entity, minority shareholders of subsidiaries, and optionees, who may become its owners in the future) that represents the results of investments

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

[4] Besides minority interests, transactions with optionees, who may become owners in the future, for example, are included.

[5] 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, which may lead to the increase in shareholders' equity but the increase is uncertain. For reclassification of items within net assets that do not arise from direct transactions as described, the portion that is not a direct transaction is included in comprehensive income.

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 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 collected. 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 the results are supported by cash flows.

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.

Relationship between Comprehensive Income and Net Income

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 (recycling) a portion of other comprehensive income that was recognized in prior periods but released from risks of investments during the current period, and (3) deducting minority interests' share in earnings.[6]

Revenues/gains

13. Revenues/gains are those items that increase net income or minority interests' share in earnings, which are generally accompanied with increases in assets or decreases in liabilities.[7]

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

[7] Examples 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 other comprehensive income recognized in prior periods, etc.).

14. Since both net income and minority interests' share in earnings are portions of the results of investments that are released from risks, revenues/gains are generally supported by (actual) cash inflows. Revenues/gains are not defined by referring to the increase in assets caused by hypothetical transactions. However, actual increases in assets that give rise to revenues/gains are not limited to the inflows of cash or cash equivalents. Allocation may be necessary for cash inflows that occur over more than one period in order to determine the amount of cash inflows for a certain period.

<u>Expenses/losses</u>

15. Expenses/losses are those items that decrease net income or minority interests' share in earnings, which are generally accompanied by decreases in assets or increases in liabilities.[8]

16. In the definition of expenses/losses, as in the definition of revenues/gains, great emphasis is placed on (actual) decreases in assets that occurred in reality. Expenses/losses are not defined by referring to decreases in assets caused by hypothetical transactions. However, allocation may be necessary for cash outflows that occur over more than one period in order to determine the amount of cash outflows for a certain period.

[8] 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 other comprehensive income recognized in prior periods, etc.).

[BASIS FOR CONCLUSIONS AND BACKGROUND INFORMATION]

<u>General Constraints on Elements</u>

17. Paragraph 3 of this Discussion Paper 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 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.[9]

<u>Classification of Components of Net Assets</u>

18. This Discussion Paper begins with providing the definition of assets and liabilities because it is expected to determine the definitions of elements easier and because it is 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 Discussion Paper defines owners' equity as a portion of net assets as net stock of investments which generates net income. As a result, in this Discussion Paper, a portion of net assets is not included in owners' equity. In order to clarify that net assets and owners' equity are not synonymous, net assets are classified into owners' equity and other components of net assets.

19. As noted in the Discussion Paper, "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 evaluating 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 Discussion Paper defines owners' equity, which corresponds to net income, as a portion of net assets attributable to the owners of the reporting entity. Owners' equity represents the net stock of investments which generates net income.

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9 A typical example of an item that meets the definition in paragraph 4 but is not included in assets from the viewpoint 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 Discussion Paper, "Objectives of Financial Reporting").

Compatibility of Net Income and Comprehensive Income

20. Although some argue that net income should be eliminated and replaced with comprehensive income, the position of this Discussion Paper 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, the Working Group decided to continuously consider net income as an independent element of financial statements.

21. This Discussion Paper considers 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, the Working Group believes that as long as comprehensive income is disclosed in addition to net income, such information would not mislead investors and decided to include comprehensive income in the system of elements of financial statements in order to be in line with global trends. However, considering comprehensive income as an independent element does not necessarily lead to the necessity of its disclosure. How to define comprehensive income and whether to disclose comprehensive income are separate issues.

Definitions of Revenues/gains and Expenses/losses

22. This Discussion Paper defines revenues/gains and expenses/losses by relating them to net income (and minority interests' share in earnings). In other words, revenues/gains and expenses/losses are not directly related to comprehensive income or changes in assets and liabilities which determine comprehensive income. If comprehensive income is defined as the difference between revenues/gains and expenses/losses, the relationship between revenues/gains and expenses/losses and changes in assets and liabilities would become more clear, but items for adjustment that are required in the process of recycling as described in paragraph 12 would also meet the definition of revenues/gains or expenses/losses, so long as both net income and comprehensive income are disclosed. However, adjustments of comprehensive income which occur as a result of recycling of other comprehensive income recognized in prior periods is merely a reclassification within net assets

caused by the release from risks that give rise to results of investments, and the adjustments are not considered to be revenues/gains or expenses/losses. Therefore, this Discussion Paper defines revenues/gains and expenses/losses by relating them to net income (and minority interests' share in earnings), and not with comprehensive income.

23. 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, focusing on their sources. However, in this Discussion Paper, 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. Revenues and gains are not distinguished, and expenses and losses are not distinguished. This is because the Working Group did not find any fundamental difference between these components that would necessitate classifying them into independent elements.

<u>Classification of Deferred Expenses and Deferred Revenues</u>

24. Although there is an argument that so-called deferred expenses do not meet the definition of assets, this Discussion Paper takes a position that deferred expenses are not necessarily precluded from recognition based on the definition of assets. If future benefits can be expected from the deferred expenses, it is possible that such deferred expenses meet the definition of assets. The position of this Discussion Paper is that if the recognition of deferred expenses as assets is precluded, it would not be because it fails to meet the definition of assets; but because it fails to meet the recognition or measurement criteria that function as a constraint.

25. Much time was spent on the discussion regarding the accounting for so-called deferred revenues.[10] Existing Japanese standards require deferred revenues to be recorded as liabilities. Based on this accounting treatment, there was a debate as to whether the definition of liabilities should be broadened to accommodate deferred revenues. However, an attempt to include deferred revenues in liabilities could lead to an excessively broad definition of liabilities that might permit a variety of items that are currently not liabilities into liabilities under the broadened definition. In order to avoid this situation, the Working Group decided that liabilities should be defined in a way that deferred revenues do not meet the definition of liabilities.

[10] The discussion in paragraph 25 also applies to negative goodwill.

Thus, according to this Discussion Paper, deferred revenues would be classified as other components of net assets within the category of net assets.[11]

[11] Some deferred revenues (such as unrealized profit on installment sales) may be interpreted as valuation accounts of specific assets.

Discussion Paper "Recognition and Measurement in Financial Statements"

[Introduction]

This Discussion Paper describes the timing the elements defined in the Discussion Paper, "Elements of Financial Statements," are recorded in financial statements and the meaning of the measurements assigned to the elements. That is, this Discussion Paper describes when to recognize each element and how to measure them. It describes (1) existing alternatives of recognition and measurement methods and (2) interpretations provided to each measurement.

In addition to major methods currently adopted in practice, the recognition and measurement methods listed in this Discussion Paper include those methods which might be used in the near future. This is because this series of Discussion Papers 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 Discussion Paper also describes some recognition and measurement methods currently not adopted in Japan.

Conversely, this Discussion Paper 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 developing standards in the future. Therefore, this Discussion Paper does not cover all possible methods of recognition and measurement.

When describing each method of recognition and measurement, this Discussion Paper focuses on the relationship between the investments by the entity and their accounting measurements. That is, this Discussion Paper addresses which recognition and measurement method can be applied to investments under 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 optimal recognition and measurement method would be chosen by clarifying the investment activity the new accounting standard is addressing.

In order to choose the optimal recognition and measurement method, there must be a common understanding regarding the status or the essence of each investment. When there is no common understanding, guidance that uniformly determines the recognition of facts and value judgments is required. However, determining such guidance is a conundrum that is beyond the scope of this Discussion Paper.

[Main Text]

Outline and Basic Concepts

[Structure of this Discussion Paper]

1. This Discussion Paper begins with describing the timing of recognizing the elements of financial statements that meet the definitions in financial statements, in other words, the triggers for recognizing the elements on the face of the financial statements. Following that, this Discussion Paper describes major measurement methods for assets, liabilities, revenues/gains, and expenses/losses. The description can be classified into a part related to assets and liabilities and a part related to revenues/gains and expenses/losses.

2. In the part related to assets and liabilities, the meanings of the measurements are described, focusing on the relationship between each measurement and the entity's investment. In particular, for measurements that directly represent the value of assets and liabilities, an independent description regarding what circumstance of investment each measurement is representing is provided.

3. The part relating to revenues/gains and expenses/losses focuses mainly on (1) when the funds invested by the entity are released from risks related to the investment and how revenues/gains that represent the results of the investments are recorded, and (2) when and how expenses/losses that represent the sacrifices for obtaining those results are recorded. This part is an extension of the description in the Discussion Paper, "Objectives of Financial Reporting," that net income is central to accounting information and the description in the Discussion Paper "Elements of Financial Statements" that net income is defined in connection with "results of investments that was released from risks." Although recognition and measurement are distinct concepts, recognition and measurement are addressed for each measurement method in this Discussion Paper because accounting procedures require recognition and measurement simultaneously.

[Definition of Recognition and Measurement]

4. Recognition in financial statements represents recording items that meet the definitions of elements on the face of the financial statements.

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

General Constraints on the Recognition of Elements

[Triggers for Recognition]

6. Elements that meet the definitions in the Discussion Paper, "Elements of Financial Statements," are recognized when a contract is executed by at least one of the counterparties (partial execution of a contract). Furthermore, changes in the value of assets and liabilities once recognized could also be a trigger for recognizing a new element.

7. 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.

8. 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]

9. In addition to the events described in paragraph 6, a certain level of probability is required in order to recognize items that meet the definitions in the Discussion Paper, "Elements of Financial Statements," in the financial statements. A certain level of probability means that a future event related to an element of financial statements is expected to occur with the likelihood above a certain level.

10. 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]

11. 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 by Historical Cost]

12. 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.

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

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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.

[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.

2) Market Price

[Definition and Classification]

14. 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 Discussion Paper 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 by Quoted Market Price]

15. 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 adjustment of the carrying amount.

16. 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]

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[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.

[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

17. 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]

18. 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 by Replacement Cost]

19. 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 adjustment of the carrying amount.[6]

2-b-ii) Net Realizable Value

[Definition]

20. 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

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discounted value mentioned below.

[6] For example, revision of the carrying amount of an asset to replacement cost may be meaningful when the revised amount of inventories under the lower of cost or market method is considered to represent the remaining usefulness of the inventories, or when the revised amount of inventories in deterioration or obsolescence is considered to represent the remaining service potentials of the inventories.

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 by Net Realizable Value]

21. Net realizable value represents the amount of funds that can be collected 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.[7]

3) Discounted Value

[Definition and Classification]

22. 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]

23. 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.[8]

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[7] For example, revision of the carrying amount of an asset to net realizable value may be meaningful when the lower of cost or market method or the compulsory devaluation of inventories are considered as a means of recognizing the expected losses on the disposal of the inventories in advance.

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

[Meaning of Measurement by Value in Use]

24. 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.

25. 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 Discussion Paper, "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.[9]

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

[Definition]

26. 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 15-17 regarding measurements using market price.

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

[Definition]

27. Discounted value where only future cash flows are continuously revised represents

[9] 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.

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.[10]

[Meaning of Measurement by this Discounted Value]

28. 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]

29. 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 by Amount to Be Collected]

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

5) Amount based on Net Assets of an Investee

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[10] 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 27.

[Definition]

31. 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.[11]

[Meaning of Measurement by Amount based on Net Assets of an Investee]

32. 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,[12] 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.[13]

Measurement of Liabilities

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

[Definition]

33. 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 by the Amount to Be Paid]

34. 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 of repayment.[14] On the other hand, when the amount to be paid is based on estimates, all the changes in estimates are recorded in net income for the period.

2) Amount of Cash Received

[Definition]

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[11] 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.

[12] Paragraph 50 describes the measurement of revenues/gains focusing on the results of the investee's activities.

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

[14] 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.

35. 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 by the Amount of Cash Received]

36. 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

37. See paragraph 22 for the definition of discounted value, the meaning of adopting discounted value, and the classification of discounted values.

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]

38. Discounted value using the risk-free rate represents a measurement determined by estimating future cash outflows[15] at the date of measurement and discounting them using the risk-free rate at the measurement date.

[Meaning of Measurement by Discounted Value Using the Risk-free Rate]

[15] Cash outflows mentioned in paragraph 38-44 include the repayment of the principal of the liability and the payment of interest.

39. 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]

40. 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]

41. 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]

42. 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.

[Meaning of Measurement by Discounted Value with Revisions Only to Future Cash Flows]

43. 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]

44. 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 by Discounted Value with No Revisions to Future Cash Flows nor Discount Rate]

45. 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

46. See paragraphs 14 and 15 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

47. 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 increases assets or the decreases in liabilities when the consideration decreases liabilities. Revenues/gains are measured based on the measurements described in paragraphs 11-46.

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

48. 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 collected (repaid) 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

49. 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.[16] The amount of revenues/gains is measured by multiplying the contract amount by the portion executed during the period.[17]

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

50. 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 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

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[16] 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.

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

the investee by the investor's interest in the investee.

Measurement of Expenses/losses

1) Measurement of Expenses/losses Focusing on Exchange Transactions

51. 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 47 for this measurement method.

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

52. 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 48 for this measurement method.

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

53. 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 49 for this measurement method.

4) Measurement of Expenses/losses Focusing on the Fact of Usage

54. 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.

55. 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

<u>Diversity in Measurement Methods</u>

56. This Discussion Paper describes various measurement methods for both assets and liabilities. This Discussion Paper 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.

57. 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 Discussion Paper leaves room for interpretation and does not deny relating measurements to more than one measurement method.

58. Measurements of some items that are recorded in today's balance sheet are not addressed in this Discussion Paper. Examples of those include "accounts receivable on completed works" recognized under the percentage of completion method and "accrued retirement benefits" recognized under the accrued benefit method. Since the measurements of these assets and liabilities can be explained primarily as the result of determining the results of investments, this Discussion Paper does not describe them as independent measurement methods of assets and liabilities.

<u>Meaning of "Release from Risks"</u>

59. The Discussion Paper, "Objectives of Financial Reporting," emphasizes the importance of profit information, and the Discussion Paper, "Elements of Financial Statements," defines net income as the results of investments released from risks.

Accordingly, this Discussion Paper 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.

60. This Discussion Paper uses the term "release from risks" as representing situations where irreversible results are obtained in light of the objective of the investment. In particular, for business investments, their results are considered to be released from risks when assets that are not subject to business risks are obtained in exchange for assets subject to business risks. In other words, the results are considered to be released from risks when independent assets ("cash"[18]) that are separated from existing business projects are obtained.[19] The traditional understanding is that investors need information regarding actually earned results in comparison with expected results. As investments are made with the expectation of obtaining future cash flows, whether the expectations are converted into facts are confirmed by understanding when and how much funds that are not constrained by business activities are obtained. This Discussion Paper leaves room for interpretation on what causes the results to be considered irreversible. Interpretations in specific cases will later be determined based on consensus during the process of developing and updating standards.

61. The notion of "realized" or "realizable" is similar to the notion of "release from risks." 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" in this Discussion Paper. However, release from risks is not determined solely by the so-called convertibility nor the disposability of the assets obtained.[20] "Realizable results" are often considered as 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."[21] Considering the

[18] Trade receivables with collection risk are usually included in "cash" in this context.

[19] When taking into consideration exchange transactions between dissimilar assets in which revenues/gains are recognized as results released from risks, 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.

[20] If "realized results" includes changes in the value of so-called financial investments that are not constrained by business activities and are not subject to business risks, this term in the broad sense is synonymous to the term "results released from risks of investments" in this Discussion Paper.

[21] In some conceptual frameworks issued overseas, an asset with an active trading market is

variety of interpretations of the term “realized,” this Discussion Paper does not use that term in order to avoid confusion.

considered to be an asset readily convertible to cash or its equivalents. A typical example of “realizable results” under this interpretation is the changes in market prices of “available-for-sale” securities. However, since disposal of “available-for-sale securities” is constrained from business activities, changes in the quoted market price of those securities are not “results released from business risks.”