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## **Convergent Evolution in Accounting Conceptual Framework: Baker and Penman(2016) and ASBJ(2006)**

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

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## **Abstract**

Criticizing the IASB's Conceptual Framework project based on the balance sheet approach, Barker and Penman (2016) have been advocating a mixed balance sheet and income statement approach. Although they do not seem to have noticed, their approach is quite similar to that of the Japanese accounting standard setter promulgated in ASBJ (2006). We will explicate the basic similarity as well as some differences between these two approaches.

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## 1. West inadvertently meets East

Under the ongoing Conceptual Framework project of the International Accounting Standards Board (IASB), recognition and measurement in accounting are heavily dependent on the so-called balance sheet approach in which income is just a periodical change of net assets, though the IASB has somewhat backtracked recently admitting the practical importance of profit or loss, i.e., traditional earnings.

However, the balance sheet approach of the IASB is not uncontroversial, to say the least. For example, Richard Barker and Stephen Penman (2016), two leading scholars of the field, have not only criticized the IASB's rigid approach but also advocated for an alternative one. They succinctly summarize their "mixed" approach as follows (p. 33):

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

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

Upon reading these lines, however, we cannot escape the feeling of *déjà vu*. The Accounting Standards Board of Japan (ASBJ), already advocated in its Conceptual Framework – officially a discussion paper – for an approach similar to the mixed one of Barker and Penman (2016) in 2006, although the two distinguished western scholars do not mention the accounting framework from the Far East.

In this note, we will explicate the basic similarity as well as some differences between the approaches of Barker and Penman (2016) and the ASBJ.

## 2. Matching and uncertainty resolution

Japan continues to keep its own accounting standards set by its accounting setting body, the ASBJ. The board has made public its own Conceptual Framework for years, although Japan's accounting "independence" is rarely mentioned when global convergence is discussed in North America and Europe.

Different from the IASB Conceptual Framework, uncertainty or risk<sup>1</sup> takes center stage in the ASBJ one. The ASBJ Conceptual Framework declares (ASBJ 2006, 2.1)

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

Its key concept is *release from risks of investments*. While this terminology used in a tentative English translation<sup>2</sup> provided by the ASBJ might engender some confusion, the concept itself is equivalent to uncertainty resolution in Barker and Penman (2016), as is clear from its explication (ASBJ 2006, 3.23).

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

It is not an overstatement to say that Barker and Penman (2016) and the ASBJ Conceptual Framework are intellectual twins though born apart in time and space. However, they are not identical and differ in an important aspect: the treatment of the matching concept.

Barker and Penman (2016) practically equate uncertainty resolution with matching in

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<sup>1</sup> The same as Barker and Penman (2016), the ASBJ uses uncertainty and risk interchangeably.

<sup>2</sup> Downloadable at [https://www.asb.or.jp/asb/asb\\_e/asbj/begriff/ConceptualFramework200612.pdf](https://www.asb.or.jp/asb/asb_e/asbj/begriff/ConceptualFramework200612.pdf). No official English translation exists.

recognition as stated above, while the ASBJ is conspicuously silent on matching.

Matching is not explicitly taken up in the ASBJ Conceptual Framework not because it is considered unimportant or useless, but because the age-old concept is regarded as a prerequisite for its mixed approach-based recognition with no need of further explication in the Conceptual Framework, which should be as concise as possible.

To tell the truth, some political considerations played a role when the Japanese framework was made public in 2006. The Japanese standard setter tried to avoid friction with the then ongoing joint project of the IASB and FASB, and its domestic supporters, who were and are called “internationalists” in Japan. That is why the ASBJ issued its Conceptual Framework as a “mere” discussion paper, and judged it unwise to stress the importance of matching when the pure balance sheet approach was at its zenith in the western standard setting bodies.

Whether explicitly mentioned or not, matching is a key concept if we want to construct a flow-centered system of accounting recognition. However, we believe *the* central concept is uncertainty resolution or release from risks, and matching is an important but subsidiary one. Although, in most cases, recognition based on matching corresponds to an accounting expression of uncertainty resolution, it does not exhaust all cases.

Barker and Penman (2016, 17) “argue that a fundamental limitation of the [IASB] Framework lies in its exclusion of any analysis of matching” and accordingly “propose an exhaustive classification that distinguishes four different levels of matching – Types 1 through 4 – each of which has different implications for the appropriate method of accounting under uncertainty” to cover all cases of uncertainty resolution to be recognized with matching.

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

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

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

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

It is true that Types 1 and 2 are indeed typical and innocuous subcategories of matching, and Type 4 is the case of immediate expensing due to non-existence of matching<sup>3</sup>, but Barker and Penman (2016) are forced to construct a recognized gain or loss of financial investment as Type 3 *ex post* matching in order to exhaust all cases as different kinds of matching.

The change of the market price should be considered the realization of cashflow if assets are held for trading. Otherwise income recognition would depend on the timing of transaction, i.e., the management's discretion, though assets themselves have no other intrinsic value than the market price. Therefore we do not need the matching concept for income recognition for the case of Type 3. The fact that uncertainty is resolved at the end of each period is sufficient for recognition. Type 3 does not belong to matching. Claiming it does sounds a category mistake.

This case shows that uncertainty resolution rather than matching is the criterion of income recognition although matching is involved in many or most cases of resolution.

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<sup>3</sup> The necessity of this type would show the difficulty of an exhaustive classification solely with matching even if Type 3 were considered a legitimate subcategory of matching.

### 3. Release from risks: A Japanese view point

As mentioned above, income recognition is based on whether investments are released from risks under the Japanese Conceptual Framework. More concretely, investment results are released from risks when their uncertainty is resolved or substantially reduced. We may say then they have become facts. Accounting information is expected to measure the determined results as timely as possible and help investors revise their ex ante expectation and make future investment decisions appropriately.

Needless to say, the said determined results or facts are those of cashflow because investment is an exchange of current certain cashflow for future uncertain one. There are two types of investment activities, operational and financial<sup>4</sup>. This dichotomous typology is also adopted in the accounting-based valuation model proposed by Feltham and Ohlson (1995).

Japanese conceptual framework indeed tries to capture the nature of two investment activities through income recognition based on the concept of release from risks.

Financial investment is the type of investment with which the company seeks for gains through arm's length transactions unconstrained by any business considerations. The archetype is investment in marketable securities held in expectations of capital gains. In this type of investment, there is no uncertainty to be resolved in the sense that the company can realize a gain or loss at any time. Because any change of the price itself is a realized result of investment, it should be recognized as income in accounting measurement. However, financial investment is not identical with investment in financial securities. For example, investment in securities held for and constrained by business considerations, even if they are vigorously traded in financial markets, is not part of financial activities but operational ones.

We expect cash flow from investment either financial or operational. However, while uncertainty of financial investment is continuously resolved, that of operational one is not resolved until cashflow from the operational activities is realized. The change of the market value should not be reflected on income except in the case of divesture or impairment because the company intends to make a profit through not the sales of the investment, but revenues it generates.

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<sup>4</sup> The said tentative translation designates operational activities as "business investments." We avoid this expression because financial as well as operational activities are undeniably business investments.

The release from risks concept is applied to recognition of not only revenues but also expenses. The outflow and depreciation of assets are recognized as expenses when they are released from risks in the sense that it is reasonable to assume that they no longer generate revenues, i.e., their expected role vanishes either favorably or unfavorably. Traditionally recognition of expenses explicated here is called matching and corresponds to Types 1 and 2 of Barker and Penman (2016).

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

While matching is considered a subsidiary concept and does not play an explicit role in income recognition in the Japanese Conceptual Framework, it is inseparably linked to uncertainty resolution and takes center stage in Barker and Penman (2016). The reason why this divergence occurs is as follows.

On the one hand, Barker and Penman (2016) are most likely to intend to simultaneously determine recognition of income and assets through matching as the necessary and sufficient condition. In their framework, balance sheet valuation and income measurement are two sides of the same coin. Therefore they have to construct the ex post matching concept, which we believe is a category mistake, in recognizing the market price change of financial investment as income.

On the other hand, firstly the Japanese standard setter had to make income information as decision-useful as possible but at the same time to avoid the explicit negation of the IASB's position when the IASB strictly adhered to the dogmatic balance sheet approach, which denied the usefulness of matching for income recognition. Secondly and more importantly, there is no need of simultaneous determination of balance sheet valuation and income measurement through matching or any other concept because balance sheet valuation and income recognition are conceptually delinked. In the Japanese Conceptual Framework, traditional net income is explicitly given primacy over comprehensive income. The former is not linked with the change of net assets through the clean surplus relation, while the latter is as in the IASB framework.

Therefore the change of asset value is a necessary but not sufficient condition for net income recognition in the Japanese framework, in which shareholders' equity and net assets are not

equated but the former is a subset of the latter<sup>5</sup>. While the clean surplus of income and shareholders' equity is maintained, the change of net assets includes cases of asset reevaluation not released from risks and consequently not recognized as income. *Other net assets* – net assets minus shareholders' equity – functions as a mezzanine or buffer account with which we can recognize the change of asset value in the balance sheet, and at the same time recognize income only when the investment is released from risks<sup>6</sup>. This account may be considered part equity, part provision or allowance.

In the final analysis, Barker and Penman (2016) and the Japanese standard setter reach the essentially same practical conclusion in income recognition through their respective “mixed” approaches despite different procedural perspectives on income recognition in the case of financial investment.

The fact that such distinguished scholars have come to the conclusion similar to, but independent of the Japanese standard, is encouraging for the members and staff of the ASBJ, who tirelessly devote their energies to make accounting information theoretically sound and practically useful.

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<sup>5</sup> In its Conceptual Framework, “due to the significance of net income,” the Japanese standard setter “defines owners' equity as a portion of net assets as net stock of investments which generates net income. As a result... a portion of net assets is not included in owners' equity” (ASBJ 2006, 3.18).

<sup>6</sup> The decoupling of income and asset recognition is a surprisingly old idea, widely discussed in the German-speaking world in the early 20<sup>th</sup> century. See, among others, Kovero (1912) .