

The Impact of Differences between Japanese-GAAP and US-GAAP on Financial Statement Information : A Case Approach

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Abstract

As business activities expanded far beyond the national boundaries, differences in accounting standards began to create serious problems in the comparability of financial statements among different countries. This paper examines the impact of the differences between J-GAAP and US-GAAP on financial statement numbers using actual financial statements of Japanese companies. Many differences were observed between financial statements prepared under J-GAAP and US-GAAP. They include scope of consolidation, scope of application of equity method, application of tax effect accounting, and accounting treatment of many items. By indicating existing differences between J-GAAP and US-GAAP, this study highlights the need for international harmonization of accounting standards.

1. Introduction

Accounting standards have been formed by each country reflecting its own social and cultural environments, including legal systems and business practices. When trade was the major form of international business, it was not necessary to examine the differences of accounting standards among different countries.

However, as business activities expanded far beyond the national boundaries, differences in accounting standards began to create serious problems of comparability between financial statements, and thus the international harmonization of accounting standards has come to be regarded as the critical issue.

Numerous studies have been performed to date to analyse the differences of Japanese accounting standards (J-GAAP) from U.S. accounting standards (US-GAAP)¹⁾. But little efforts have been offered to make clear the quantitative impact of the differences between J-GAAP and US-GAAP²⁾. This is mostly because the data necessary for such an analysis were not available. For example, although SEC made a survey on financial statement reconciliations by foreign registrants of almost 40 countries, it could not indicate any quantitative

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difference between J-GAAP and US-GAAP, because "all surveyed Japanese registrants file financial statements that are prepared in accordance with U.S.GAAP"³⁾.

In this paper, the impact of the differences between J-GAAP and US-GAAP on financial statement numbers is analyzed based on the consolidated financial statements of actual Japanese companies.

2. Overall Comparison of Performance under Japanese-GAAP and US-GAAP

First, a survey of Japanese companies was made in order to discover which accounting standards were used to prepare financial statements. Thirty-two companies were selected from among the big corporations which prepared annual reports in English for foreign readers. Table 1 classifies these sample companies by the accounting standards they use and the industries they belong to.

As can be seen in Table 1, there was only one company that applied International Accounting Standards (IAS) to prepare its consolidated financial statements for the annual report. For the purpose of this paper, those four companies were selected which applied J-GAAP to prepare consolidated financial statements for the securities report (Japanese counterpart of Form 10-K), while also applying US-GAAP to prepare consolidated financial statements for the annual report.

Let us first observe differences in overall results of net sales and net income, which arise from applying J-GAAP and US-GAAP. Comparative data are shown in Tables 2-5, which show the results of operations from Companies A, B, C and D, respectively. For Company A,

Table 1 Classification of Accounting Standards used to Prepare Consolidated Financial Statements

Securities Report		Annual Report	Number of sample companies by industry					
Parent F/S	Consolidated F/S	Consolidated F/S	Electronics	Automobile	Trading	Retail	Others	Total
J-GAAP	J-GAAP	J-GAAP	2	6	2	4		14
J-GAAP	US-GAAP	US-GAAP	7	1	4	1		13
J-GAAP	J-GAAP	US-GAAP				2	2	4
J-GAAP	J-GAAP	IAS	1					1
Total			10	7	6	7	2	32

(Note) J-GAAP = Japanese Accounting Standards
 US-GAAP = US Accounting Standards
 IAS = International Accounting Standards

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data were available for three years, but for the other companies data were available only for two years.

From Table 2 (Company A), it is found that the difference in net sales between J-GAAP and US-GAAP is trivial. Net income, however, shows a bigger difference. For 1993, net loss under J-GAAP is 35.0 % of net loss under US-GAAP. On the contrary, net income under J-GAAP is 167.5 % of net income under US-GAAP in 1994. As a natural result, differences in the ratio of net income to net sales show significant differences between J-GAAP and US-GAAP.

While the differences in net sales under J-GAAP and US-GAAP in Companies A, B and D are relatively small, the differences in Company C are significant. It is noticeable that the amount in Company C (leasing company) is completely different because the accounting standards for leases under J-GAAP and US-GAAP are quite different. In the case of

Table 2 Company A : Net sales and net income under J-GAAP and US-GAAP

(billion yen)

	1993			1994			1995		
	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$
Net sales	283.8	282.9	100.3%	271.9	272.0	100.0%	284.1	284.0	100.0%
Net income	- 1.4	- 4.0	(35.0%)	12.2	7.3	167.5%	4.6	5.4	85.2%
Net income/net sales	- 0.5%	- 1.4%	-	4.5%	2.7%	-	1.6%	1.9%	-

Table 3 Company B : Net sales and net income under J-GAAP and US-GAAP

(billion yen)

	1994			1995		
	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$
Net sales	1,651.7	1,756.5	94.0	1,803.9	1,900.4	94.9%
Net income	25.9	28.0	92.5%	23.2	22.2	104.5%
Net income/net sales	1.6%	1.6%	-	1.3%	1.2%	-

Table 4 Company C : Net sales and net income under J-GAAP and US-GAAP

(billion yen)

	1994			1995		
	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$
Net sales	979.3	325.4	301.0%	974.4	310.8	313.5%
Net income	6.9	18.0	38.3%	7.0	17.1	40.9%
Net income/net sales	0.7%	5.5%	–	0.7%	5.5%	–

Table 5 Company D : Net sales and net income under J-GAAP and US-GAAP

(billion yen)

	1994			1995		
	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$	J-GAAP (A)	US-GAAP (B)	$\frac{(A)}{(B)}$
Net sales	1,377.9	1,419.3	97.1%	1,451.1	1,486.3	97.6%
Net income	– 1.5	– 9.7	(15.5%)	– 5.1	– 7.6	(67.1%)
Net income/net sales	– 0.1%	– 0.7%	–	– 0.4%	– 0.5%	–

Companies B and D, business activities and fund raising are limited to the domestic market. On the other hand, Companies A and C raise funds from the European and American capital markets as well as from the domestic market, and have subsidiaries overseas, which have caused major differences. More specifically, “exchange rate” and “goodwill” differences impacted the financial statements of Companies A and C.

Although the ratios of net income to net sales for Company B seem to be small, it is still possible to indicate that these differences cause a problem in understanding their performance since they belong to industries with relatively low profit ratios.

3. Analysis of the Differences in the Financial Statements

In order to compare the differences in the accounting numbers presented in consolidated financial statements prepared under J-GAAP and US-GAAP, Company A is used for the case study in this paper. Company A has used US-GAAP for its annual reports for more than ten years because it issues ADR (American Depositary Receipts).

3.1 Comparing Income Statement Numbers (See Exhibit 1)

(1) Net Sales

Due to the difference in the scope of consolidation under J-GAAP and US-GAAP, there is a small amount of difference (100 billion yen in 1995) in net sales. In preparing consolidated financial statements, all subsidiary companies should be consolidated. However, J-GAAP allows the company to exclude subsidiaries from consolidation if they are not material. In Japan, there used to be a "ten percent test" (now it is 3 to 5 percent) to determine immaterial subsidiaries to be excluded from consolidation. As a result, more subsidiaries were consolidated under US-GAAP than under J-GAAP.

Under US-GAAP, "Allowance for sales returns" is deducted from net sales, while it is accounted for as a cost under J-GAAP. This treatment has an effect to show the amount of net sales under US-GAAP smaller than under J-GAAP.

(2) Cost of Goods Sold

Cost of goods sold is almost identical under both J-GAAP and US-GAAP for 1994 and 1995, but the difference of 4 billion yen is observed in 1993. Under J-GAAP, Company A applies the "cost method" to manufactured products, while it applies the "lower of cost or market" method to raw materials and merchandise inventory. Under US-GAAP, all of these assets are accounted for by "lower of cost or market" method. Under the conditions where market price fluctuates drastically, the difference will be large.

(3) Selling, General and Administrative Expenses

In the annual report, "depreciation expense" is included in "selling, general and administrative expenses", and cannot be identified as a separate item. However, at least it is clear that the straight-line method is used under US-GAAP, while the declining balance method is used under J-GAAP. Therefore it is expected that the depreciation expense will be larger under J-GAAP.

"Research and development costs" is a little smaller under US-GAAP. Because the composition of research and development costs is not clear, the reason for the difference cannot be indicated.

Under J-GAAP, "liability for retirement payment to employee" is measured at the current amount to be paid. But under US-GAAP, it is the present value obtained by discounting future cash-flows. Thus there can be a big difference between liabilities for retirement payments under J-GAAP and US-GAAP.

There are also differences in the accounting treatments for "compensated absence" and "enterprise tax" which affect the amount of income.

(4) Other Items

The total amount of "interest received from bank accounts and securities" and "dividends received" under J-GAAP is nearly the same as under US-GAAP. The amount of "interest and

discount expense” and “interest expense on bond” under J-GAAP is also nearly the same as under US-GAAP.

It is not clear how “other non-operating revenue” and “other non-operating expense” are treated under US-GAAP.

There is little difference between the amount of “indemnity after manufacturing and selling contract” under J-GAAP and US-GAAP. Under J-GAAP, “gain from sales of investment securities in affiliated companies” in 1994 is bigger by 460 million yen than under US-GAAP. The amount of this difference lies in the fact that “lower of cost or market” method or “cost” method can be applied under J-GAAP to each type of securities, while “lower of cost or market” method is applied only to the total amount of securities under US-GAAP.

In 1995, the “capital gain or loss from marketable securities” is shown under J-GAAP, but it is not shown under US-GAAP. The reason for this is not clear.

There is a substantial difference in consolidation goodwill. Under J-GAAP, it is called “consolidation adjustment account”, and is amortized within 5 years, while under US-GAAP it is amortized over 40 years.

There is also a difference occurring on “minority interest” and “investment income from equity method”. This is again partly due to the difference of the scope of consolidation and the scope of application of the equity method.

“Foreign currency translation adjustment account” differs, because modified temporal method was used under J-GAAP, while current rate method was used under US-GAAP.

3.2 Comparing Balance Sheet Numbers (See Exhibit 2)

(1) Current Assets

In 1995, “cash and cash equivalent” under J-GAAP is greater than under US-GAAP by 32.9 billion yen. On the other hand, “money in trust” under J-GAAP is smaller than under US-GAAP by 33.8 billion yen. Combined together, the amount becomes almost equal as can be seen in Table 6. Furthermore, part of “cash and cash equivalent” under J-GAAP may be treated as part of “marketable securities” under US-GAAP.

The difference in “trade notes receivable and trade accounts receivable” occurs due to the different scope of consolidation. The difference in securities occurs partly because the “lower of cost or market” method or “cost” method can be applied under J-GAAP, while only “lower of cost or market” method is applied under US-GAAP. The difference in inventories is due to the fact that Company A applied the “cost” method under J-GAAP and the “lower of cost or market” method under US-GAAP. The difference in “prepaid taxes” or “deferred tax” is significant. The difference is caused because tax effect accounting was not applied under J-GAAP.

Table 6 Cash and cash equivalent of Company A

(billion yen)

	J-GAAP			US-GAAP		
	1993	1994	1995	1993	1994	1995
Cash and cash equivalent	29.1	56.9	73.2	27.9	53.7	50.3
Cash in trust	9.9	7.5	7.6	4.0	7.5	41.5
Total	39.0	64.4	80.8	31.9	61.2	81.8

(2) Long-term Assets

The difference in depreciation expense affects the difference in “property, plant and equipment”. Furthermore, under US-GAAP, part of the leased assets is accounted for as assets, while it is off-balance sheet under J-GAAP. The total amount of “goodwill” and “other intangibles” (patents, etc.) is greater under J-GAAP than under US-GAAP. It seems that the amortization periods of goodwill affects this amount.

“Investment securities in affiliated companies” and “long-term loans receivable” are presented separately under J-GAAP. The difference in the total amount occurs because of the different valuation methods used.

(3) Current Liabilities

The differences in “trade notes payable”, “trade accounts payable” and “loans payable” are mainly due to the difference in the scope of consolidation. Again, tax differs because tax effect accounting is not applied under J-GAAP. The “estimated liability bonus” differs in 1993 and 1994 between J-GAAP and US-GAAP, although it is almost the same in 1995. The reason for this difference is not clear.

(4) Long-term Liabilities

There exists a significant difference in “long-term liabilities” under J-GAAP and US-GAAP. This is partly due to the different accounting treatment for “retirement payment and pensions”.

4. Conclusion

In this paper, the quantitative impact of the differences between J-GAAP and US-GAAP on financial statements was examined. Although the Japanese accounting system was established soon after World War II with a strong influence from the US accounting system, there are currently significant differences in financial statement numbers for the same

transactions.

In this case study, many differences were observed between financial statements prepared under J-GAAP and those prepared under US-GAAP. They include scope of consolidation, scope of application of equity method, application of tax effect accounting, and accounting treatment of many items (eg. scope of cash and cash equivalent, scope of securities, valuation of securities, valuation of inventories, method of depreciation, research and development costs, retirement payment and pensions, compensated absence, enterprise tax, consolidation goodwill, foreign exchange gains and losses, lease transactions, estimated liability bonus).

Today, with the emergence of the global economy, there is a strong demand towards the international harmonization of accounting standards. By indicating existing differences between J-GAAP and US-GAAP, this study highlights the need for international harmonization of accounting standards.

Recent revisions of accounting standards in Japan are expected to eliminate some of the differences indicated in this study. As of January 1998, accounting treatments of foreign currency translations and lease transactions are similar to those of the United States. On June 6, 1997, the revision of accounting standards for consolidated financial statements was promulgated. By this revision, control concept is adopted to decide the scope of consolidation, tax effect accounting is introduced, consolidated cash flow statement becomes one of the major financial statements, interim consolidated financial statements are prepared, and several other amendments were made. It is expected that, following this revision, consolidated financial statements under J-GAAP will become more comparable with those prepared under US-GAAP or IAS.

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Notes

- 1) See, for example, Price Waterhouse, *Comparability of Financial Statements: International Survey* (1991); Coopers & Lybrand, *International Accounting Summaries* (Wiley, 1991). For the differences between J-GAAP and UK-GAAP, see Coopers & Lybrand, *Accounting Comparisons UK/Japan* (1991).
- 2) An example of such an analysis is provided by Paul Aron, "Japanese P/E Ratio in an Environment of Increasing Uncertainty," in Frederick D.S. Choi, ed., *Handbook of International Accounting* (Wiley, 1991), Ch. 8. The quantitative analysis of major differences in US/UK accounting principles is given by Lee H. Radebaugh and Sidney J. Gray, *International Accounting and Multinational Enterprises (Third Edition)* (Wiley, 1993), Ch.14.
- 3) SEC Division of Corporation Finance, *Survey of Financial Statement Reconciliations by Foreign Registrants* (May 1, 1993), p.21.

EXHIBIT 1 CONSOLIDATED INCOME STATEMENTS [Company A]

(in million yen)

	Securities Report (Japanese GAAP)			Annual Report (US GAAP)		
	1995	1994	1993	1995	1994	1993
I Net sales	284,104	271,895	282,844	284,030 (247,228)	271,986 (234,944)	282,918 (236,085)
II Cost of goods sold	137,012	130,674	141,486	136,960	130,700	137,255
Gross profit on sales	147,091	141,221	141,358			
Adjusted allowance for sales returns	74	-3	13			
Adjusted gross profit on sales	147,017	141,225	141,344			
II Selling, general and administrative expenses	123,970	126,231	129,967			
1. Selling expenses	13,990	13,474	14,671			
2. Advertising expenses	6,506	5,672	6,582			
3. Allowance for doubtful accounts	-	-	32			
4. Salary, bonus	27,851	26,197	26,462			
5. Provision of reserve for bonuses	3,702	3,612	3,505			
6. Provision of reserve for retirement allowances	2,266	2,128	1,883			
7. Provision of reserve for officers' retirement allowances	205	198	236			
8. Depreciation expenses	2,525	3,084	3,249			
9. Enterprise tax (local taxes)	3,454	6,324	4,428			
10. Adjusted enterprise tax etc	356	-688	-993			
11. Provision of reserve for tax: long-term	14	68	70			
12. Return of cost from tie-up companies	-7,156	-4,762	-5,598			
13. Research and development costs	36,777	36,828	40,083	36,486	36,719	39,805
14. Other cost	33,476	34,091	35,351			
Operating profit	23,046	14,993	11,376			

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IV Non-operating revenue	9,684	11,207	14,037		6,229	6,578	9,354
1. Interest received from bank accounts	2,351	1,122	2,418				
2. Interest received from securities	2,574	3,599	4,956				
3. Dividends received	626	1,758	866				
4. Gain from sales of marketable securities	757	-	-				
5. Other non-operating revenue	3,375	4,727	5,797				
V Non-operating expenses	11,956	11,737	11,324		7,135	6,768	9,041
1. Interest and discount expense	4,174	4,126	5,259				
2. Interest expense on bonds	2,408	2,691	2,516				
3. Loss from sales of marketable securities	2,515	-	-				
4. Translation loss	-	2,581	-				
5. Other non-operating expense	2,857	2,338	3,547				
Ordinary profit	20,775	14,464	14,090		1,601	23,703	-3,269
VI Special income	517	25,367	1,375				
1. Indemnity after manufacturing and selling contract	-	23,245	-				
2. Gain from sales of investment securities - in affiliated companies	-	1,815	1,375			1,355	-
3. Gain from sales of land	-	220	-				1,357
4. Reversal of allowance for doubtful accounts	517	86	-				
VII Special loss	-	3,515	-				
Amortization of goodwill	-	3,515	-				
Net income before adjustment of taxes etc	21,292	36,317	15,466		1,932	2,016	2,218
Income taxes etc (national & local taxes)	13,224	24,244	17,291		25,837	40,585	11,806
Adjustment of income taxes etc	1,393	-2,611	-3,514		20,563	29,046	14,978
Provision of reserve for taxes: long-term	53	253	252		(17,042)	(30,472)	(21,722)
Minority interest	181	87	230		(3,521)	(-1,426)	(-6,744)
Amortization of consolidation adjustment account	2,551	2,452	2,680				
Equity in earnings of affiliated companies	-81	2	876		-81	49	871
Translation adjustment account	-676	-358	-945				
Net income	4,645	12,247	-1,404		5,355	11,490	-4,043
						-4,226	-
					5,355	7,264	-4,043

EXHIBIT 2 CONSOLIDATED BALANCE SHEETS [Company A]

(in million yen)

	Securities Report (Japanese GAAP)			Annual Report (US GAAP)		
	1995	1994	1993	1995	1994	1993
I Current assets						
1. Cash and cash equivalents	300,879	305,426	281,637	308,290	312,390	288,678
2. Money in trust	73,204	56,882	29,122	40,334	53,739	27,923
3. Trade notes receivables and trade accounts receivables	7,630	7,503	9,922	41,484	7,500	3,956
	101,827	93,018	97,428	100,529	91,566	96,648
				(23,489)	(25,283)	(30,598)
4. Marketable securities	63,939	93,517	86,747	(78,297)	(67,726)	(67,568)
5. Inventories	32,821	35,144	36,809	(-1,257)	(-1,443)	(-1,518)
6. Prepaid taxes (short term)	3,242	4,260	3,438	79,361	99,673	97,098
7. Others	19,471	16,537	19,639	32,821	35,145	37,431
Allowance for doubtful accounts	-1,256	-1,436	-1,469	1,699	13,010	11,079
				12,062	11,757	14,543
				(Allowance for doubtful receivable)		
II Long-term assets and intangible assets						
(1) Property, plant and equipment	142,153	145,328	153,487	75,768	73,717	81,660
1. Buildings and structures	76,903	74,645	78,810	(67,877)	(64,507)	(62,940)
2. Machinery and equipment	35,000	34,651	34,123	(104,637)	(100,090)	(101,751)
3. Land	17,039	17,206	18,913	(13,795)	(12,679)	(13,106)
4. Construction in progress	13,008	12,038	12,144	(3,889)	(4,153)	(6,557)
5. Others	4,114	4,269	6,331	(-114,430)	(-107,712)	(-102,694)
(2) Intangible assets	7,741	6,478	7,298	72,521	61,321	71,951
1. Goodwill	3,625	3,706	8,511	1,611	2,240	7,576
2. Others	1,811	2,240	7,065			
(3) Investments and other assets	1,814	1,466	1,446			
1. Investment securities in affiliated companies	61,623	66,977	66,165	50,936	29,994	30,772
2. Long-term loans receivable	26,810	29,308	24,952	1,873	1,794	2,104
3. Prepaid taxes (long term)	2,623	3,063	4,371			
4. Others	19,362	20,049	17,615	417	7,184	9,600
Allowance for doubtful accounts	12,865	14,930	19,656	15,329	17,579	18,791
	-38	-375	-429	2,355	2,530	3,108
III Consolidation adjustment account						
IV Translation adjustment account	71,848	74,048	75,299	56,425	64,275	71,376
TOTAL ASSETS	525,170	534,121	524,583	513,004	511,703	513,665

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	Securities Report (Japanese GAAP)			Annual Report (US GAAP)		
	1995	1994	1993	1995	1994	1993
I Current liabilities						
1. Trade notes payable and trade accounts payable	165,218 38,368	125,161 40,035	120,779 40,890	173,658 36,090 (9,650) (26,440)	141,851 39,084 (3,017) (36,548)	132,779 39,565 (3,017) (36,548)
2. Short-term loans payable and notes payable	27,531	24,607	26,753	26,550 37,266	24,405 156	27,292 89
3. Bonds with stock warrants	50,074	—	—			
4. Accounts payable-other	17,543	14,877	19,387	17,706	14,913	15,400
5. Accrued income taxes etc	7,578	17,830	11,229	9,533	22,367	14,243
6. Accrued enterprise taxes etc	1,954	4,748	2,852			
7. Accrued expenses	10,899	9,802	6,742	15,531	13,138	15,087
8. Reserves	8,631	7,883	8,058			
Reserve for employee's bonuses	(7,299)	(6,637)	(6,512)	7,299	7,164	7,129
Reserve for sales rebates	(948)	(936)	(1,232)			
Reserve for sales returns	(384)	(309)	(313)			
9. Others	2,636	5,375	4,865	23,683	20,624	13,973
II Long-term liabilities						
1. Bonds	123,370	178,887	178,224	113,423	156,696	164,369
2. Bonds with stock warrants	2,407	2,981	2,801			
3. Convertible bonds	11,176	61,250	61,250			
4. Long-term loans	28,785	28,785	28,785	79,171	123,477	131,179
	39,124	46,235	47,297	734	1,069	1,875
5. Reserves	41,030	38,202	35,305	33,518	32,150	31,315
Reserve for retirement allowance	(39,630)	(36,344)	(33,555)			
Reserve for officers' retirement allowance	(1,148)	(963)	(1,177)			
Reserve for tax payment	(251)	(894)	(573)			
6. Others	848	1,432	2,784			
III Minority interest	1,225	807	1,422	1,013	645	1,314
Total liabilities	289,814	304,855	300,425			
I Capital stock	30,697	30,697	30,697	224,910	212,511	215,203
II Additional paid-in capital	49,343	49,343	49,343	30,698	30,698	30,698
III Retained earnings	4,497	4,185	3,939	58,546	58,546	58,546
IV Other retained earnings	150,821	145,046	140,179	4,625	4,360	4,065
				13,909	—	—
				147,399	144,717	140,638
				(-30,264)	(-25,802)	(-18,742)
V Treasury stock	(-3)	(-8)	(-2)	(-3)	(-8)	(-2)
Total shareholders' equity	235,356	229,265	224,157			
Total liabilities and shareholders' equity	525,170	534,121	524,583	513,004	511,703	513,665