

## ARTICLES

### Problems of Accounting Standard-Setting in Japan

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#### 1. Coexistence of Two Standard-Setting Bodies

Since the last half of the 1990's, Japan carried out reforms of the accounting system, which are often referred to as the "Accounting Big Bang". The substance of the reforms was to make Japanese accounting standards comparable with internationally accepted ones.

In the rest of the world, however, accounting standards had been revised and the standard-setting mechanism changed more rapidly than in Japan. During 1997-1999, the Strategy Working Party of IASC (International Accounting Standards Committee) discussed the shaping of IASC for the future<sup>1</sup>. In the discussion, US and European countries had apprehensions concerning Japan in that Japan might not be able to correspond to the activities of IASB (International Accounting Standards Board), which was soon to be newly established. This was because they thought that the BADC (Business Accounting Deliberation Council), the standard-setter of Japan, did not satisfy the following conditions which were required for a standard-setter. (1) Full-time staff; (2) Transparency based on due process (3) Independence from any interested parties All the members of BADC are part-time, and BADC does not show the explicit due process. Furthermore, it is felt that BADC cannot maintain independence, since it belongs to the public sector of the Financial Services Agency.

Thus it was understandable that concern was expressed that Japan could not actively contribute to IASB in the era of international convergence of accounting standards. Japan did not necessarily show a prompt response to this concern, but a new foundation was finally established by the efforts of the related parties. This is the FASF (Financial Accounting Standards Foundation), which was established in July 2001. Then, in August 2001, the ASBJ (Accounting Standards Board of Japan) was established, which satisfied the conditions mentioned above.

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<sup>1</sup> For the proposal, see International Accounting Standards Committee, *Recommendations on Shaping IASC for the Future*, November 1999.

Today, in Japan, there is an irregular situation where the public sector (BADC) and the private sector (ASBJ) exist together and where both set accounting standards in close cooperation. Thus, the purpose of this paper is to serve for the improvement of Japanese accounting standard-setting by showing some of the issues we face.

## **2. The Dilemma of New Accounting Standards: Lack of Comparability**

By the “Accounting Big Bang”, Japanese accounting standards had been set or revised so that they reflect international trends. In that sense, the financial statements of Japanese companies prepared in accordance with the new accounting standards should be superior in comparability to previous financial statements. However, we must confess that there still exist many problems in the comparability of current financial statements of Japanese companies, although this situation may be regarded as temporary or transitional.

Impairment of fixed assets may show an example of such a case. On August 9, 2002, BADC published the Accounting Standard for Impairment of Fixed Assets.<sup>2</sup> According to the Standard, accounting for impairment will be introduced from the fiscal year beginning on April 1, 2005. The Standard indicates that it is appropriate to admit the application from the fiscal year beginning on April 1, 2004. Companies will also be allowed to voluntarily apply accounting for impairment from the fiscal year beginning on April 1, 2003. As such, while some financially strong companies may choose the early application of the standards, other companies may not apply it until the standard is enforced. This situation will result in a lack of comparability among companies.

There are other factors which make the situation more complex. One is the fact that some leading Japanese companies prepare financial statements in compliance with the US standards. Accounting standard for impairment had been already applied by those companies, and there is no comparability with the companies whose financial statements are prepared based on Japanese standards. In addition to that, there was the special factor of the Land Revaluation Law. It was not an accounting standard, but was a law in force only for a limited period of time which allowed the revaluation of land. Its application was optional. Some companies impaired certain assets by offsetting the gain created by the application of the Land Revaluation Law. On the other hand, some companies cannot impair their assets because of their weak financial position. Thus, under the situation where some companies apply impairment accounting while others do not apply it due to various underlying factors, comparability of financial statements is not secured. Such a situation can also be seen in areas

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<sup>2</sup> ADC “Opinion on Setting Accounting Standards for the Impairment of Fixed Assets,” (August 9, 2002).

other than impairment.

For the above reasons, although the Japanese accounting standards have been harmonized with international ones, they will not bring about the comparability of financial statements for the time being. In order to avoid a misleading situation, users of financial statements should not observe superficial income numbers, but should read financial statements carefully with enough understanding of the situation.

### **3. Lack of a Conceptual Framework for Standard-Setting**

Standard-setting in Japan embraces a fundamental problem. This is the non-existence of a conceptual framework that provides a common basis for discussion. The FASB (Financial Accounting Standards Board) of the United States, for example, has a conceptual framework, which FASB refers to in setting accounting standards. Although there is sometimes controversy as to whether FASB applies the conceptual framework rigorously, FASB clearly gives serious consideration to the conceptual framework. In Japan, however, there is no explicit conceptual framework. This is one of the factors which confuses the situation concerning standard-setting in Japan.

The most obvious confusion can be seen in “measurement”. In Japan, it is generally understood even today that historical cost is the theoretical basis for measurement. The accounting reforms introduced new accounting standards that use the concepts of market value, fair value and discounted future cash flows as the measurement bases. This means that Japanese accounting standards today take the approach of multiple measurement bases. While accountants understand it well, there are many people who do not do so, in a situation where the old historical-cost-based Business Accounting Principles still survive and where there is no explicit conceptual framework.

Let us again use accounting for impairment as an illustration. When BADC discussed the valuation of fixed assets, investment property was also included within the scope of discussion. IAS No.40 “Investment Property” requires an enterprise to choose either the fair value model or the cost model for the subsequent measurement of investment property, and requires an enterprise that applies the cost model to disclose the fair value of investment property.<sup>3</sup> BADC, however, decided to make the measurement and/or disclosure of fair value part of a future agenda. The rationale for this decision was not a theoretical one, but was a practical consideration: the postponement was in order to adjust conflicting interests. As a

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<sup>3</sup> IAS No.40, “Investment Property,” paras.24 and 69.

result, the treatment of investment property in Japan will be different from that of IAS.

Let us then highlight the disadvantage of the lack of conceptual framework by observing the issue of business combinations. BADC has been discussing the issue of accounting for business combinations. The international trend shows that the pooling method will be eliminated and the purchase method will be approved as the only method to be applied. In Japan, however, there still are strong opinions supporting the pooling method. The reason is based on the fact that the majority of business combinations in Japan take the form of mergers between equals.<sup>4</sup> The United States has a history of wide range of discussions on the issue of business combinations including the equal merger, and reached the conclusion to eliminate the pooling method. The Japanese assertions that support the pooling method may be regarded as self-centered or egoistic, since the opinion was not developed at the conceptual level.<sup>5</sup> And, in fact, there is a tendency within Japan to think that domestic issues are more important than international harmonization. This is an attitude that completely disregards the background for the establishment of ASBJ. If Japan is to assert and justify its position, it is better to develop the conceptual discussion in a manner that can be understood and accepted internationally.

#### **4. Limited Contribution of Accounting Research for Standard-Setting**

As was indicated above, standard-setting in Japan is not based on an explicit conceptual framework. This does not mean, however, that no theoretical discussion or research is performed prior to standard-setting. In particular, BADC paid serious attention to the preceding research for those accounting standards which were set after the "Accounting Big Bang". The research activities of COFRI (Corporation Finance Research Institute), which can be regarded as the predecessor of ASBJ, had a special importance. In fact, the research results of COFRI widely served to set accounting standards on consolidation, foreign currency translation, financial instruments, pensions, impairment, stock options and business combinations. Furthermore, COFRI's research covered a wide variety of topics such as disclosure systems, relations with the Commercial Code, electronic disclosure, international harmonization and conceptual framework.<sup>6</sup> But the research activities of COFRI mainly focused on the legal aspects or international comparison of the issue, and thus less attention was paid to empirical research on the impact of accounting standards. This makes a clear contrast to the United States where much empirical research on accounting standards is

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<sup>4</sup> *Nihon Keizai Shinbun*, April 19, 2002.

<sup>5</sup> *Nihon Keizai Shinbun*, December 13, 2001.

<sup>6</sup> The research activities of COFRI are summarized in *COFRI Journal*, Vol.43 (July 2001).

performed.<sup>7</sup>

There is also a problem of the relationship between the standard-setter and academic organizations. In the United States, the AAA (American Accounting Association) was one of the founding members of FASB, while in Japan, the JAA (Japan Accounting Association) was not included in the founding members of FASF or ASBJ. In the United States, a committee within AAA responds to the exposure drafts of FASB. In Japan, some JAA members may be involved with standard-setting as individuals, but JAA does not form a committee to prepare a comment letter to the exposure draft of BADC or ASBJ, because most of the JAA members do not think it necessary.

## 5. Cost of Standard-Setting

There is another important issue concerning standard-setting apart from the academic ones. This is the issue of funding. As BADC is a public-sector organization, the cost of its activities is covered by the government (Financial Services Agency). On the other hand, ASBJ is a private-sector organization, and funds for its activities must be raised from non-governmental circles.

According to the report by FASF, it has difficulty in funding due to an insufficient number of members. As of July 10, 2002, only 1,125 companies registered as the members, which is only about 30 percent of the 3,500 listed companies. The number of the members including other organizations like audit corporations and financial institutions is 1,498, and there are 108 individual members. This is not sufficient to support the activities of ASBJ. As a result, an annual deficit of 150 million yen is expected for its annual budget of 800 million yen. The Financial Services Agency provides a subsidy of 150 million yen, but it is only on condition that the accounting standards and guidelines be delivered free of charge.

The accounting standards of IASB or FASB are sold at cost. In Japan, it is a long-standing belief that accounting standards are free, and government policy makes it difficult to charge for them. If fund raising for standard-setting continues to be unsatisfactory, we must discuss whether to charge for accounting standards in the future. In order to avoid such a situation, all the related parties including companies should recognize that standard-setting is a costly

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<sup>7</sup> This is a statement that needs confirmation, since Professor Fujii indicates that the role of accounting research in the US is quite limited for standard-setting. See Hideki Fujii "Role and Methodology of Accounting Research 1: Decision Usefulness Approach as a System," *Kigyo Kaikei*, Vol.54, No.7 (July 2002), pp.100-101.

activity and that they should share the responsibility of setting accounting standards. It is not an easy task because this attitude relates to the Japanese culture. However, it is no doubt one of the important issues that FASF must cope with.

## **6. Internationalization of Accounting and Importance of Education**

In 2001, the Ministry of Economy, Trade and Industry carried out a survey of the public companies., which presents interesting results concerning accounting reforms in Japan.<sup>8</sup> According to the survey, 54.5% of the responding companies evaluated the recent revision of accounting standards as “useful for adequate disclosure of financial information”. And 38.8% of companies responded that “revision is slow paced”. This result may show that many companies accept the accounting reforms positively.

Another interesting survey result can be seen in the accounting standards that companies wanted to adopt in the near future. While 55.9% replied that they prefer “Japanese standards” and 5.6% replied “US Standards”, 30.9% preferred to adopt “IAS”. Especially for those big companies with a capital stock of 100.1 billion yen or more, 28.8% preferred “US standards” and 30.8% preferred “IAS”. The total of these companies (59.6%) far exceeded the companies which preferred “Japanese standards” (36.5%).

Regarding the internationalization of accounting, 60.1% supported “international harmonization”, and 21.2% supported “international convergence”. The total of these two responses was 81.3%. On the contrary, only 14.3% replied that neither harmonization nor convergence was necessary.

The linkage between Japanese accounting and the international trend will become stronger and stronger in the future. Education will play a key role if Japan tries to proceed with accounting reforms keeping pace with international trends, and to contribute to the international development of accounting. The JAIAS (Japanese Association for International Accounting Studies) exists as an organization to foster international accounting research, and there is the JIAE (Japanese Institute of International Accounting Education) as an organization for international accounting education. However, we still cannot say that we have sufficient accountants who can contribute internationally. It is necessary that all the accounting societies in Japan make every effort to educate real international accountants.

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<sup>8</sup> Ministry of Economy, Trade and Industry, “A Survey of Domestic Companies on Accounting Reforms,” (March 2002).