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An Update for Comparison between Japanese GAAP and International Accounting Standards

Yoshinori KAWAMURA*

Abstract

The accounting "Big Bang" in Japan over the years resulted in comprehensive reform in accounting standards and changes in social and corporate environment. This article highlights how Japanese accounting standards and standard-setting process have been improved, and provides some implications for the future.

1. Introduction

During the last several years, accounting standards in Japan have been drastically revised or newly established, so that they are harmonized with international accounting standards (IASs)[1] and the U.S. generally accepted accounting principles (GAAP). The latest movement in the Japanese GAAP is a driving force toward principles that are "free, fair, and compatible with global standards," producing many changes in the social and legal environment and corporate management in Japan. This comprehensive reform in accounting standards and environments in Japan is referred to as the "Accounting Big Bang." After the "Big Bang," it would be fair to say, I believe, that Japanese GAAP are now compatible, in most areas, with internationally accepted accounting standards. At the same time, even today, if we examine them in detail, there still remain major differences between Japanese GAAP and IASs, not only in their conceptual foundation but also in the specific accounting requirements.

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* Yoshinori Kawamura is an associate professor, Waseda University, Japan, and a technical member of the Business Accounting Deliberation Council. This article is part of the results of the work of the 2002-2003 Special Committee of the Japan Accounting Association chaired by Dr. Kazuo Hiramatsu, president of Kwansei Gakuin University. It is also based on a Japanese version, coauthored by Mr. Kawamura and Mr. Hidetsugu Umehara, Chuo University, Japan.

1 IASs, as used in this article, include International Accounting Standards, which are set forth by the International Accounting Standards Committee (IASC), and International Financial Reporting Standards (IFRS), which are set forth by the International Accounting Standards Board (IASB). The IASB was established in April 2001 toward international convergence of accounting standards around the world, succeeding to the work of the IASC.

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The purposes of this article[2] include (1) providing a brief summary of the existing standard-setting process and financial reporting environment in Japan, (2) providing a summarized comparison between Japanese GAAP and IASs, and (3) presenting the analytical implications of the comparative study.

2. Standard-Setting and Financial Reporting Environment in Japan

2.1 Standard-Setting

Before we identify differences between Japanese GAAP and IASs, it would be beneficial for readers to review the accounting standard-setting process in Japan.

Since the end of World War II, Japanese GAAP have been set forth by the Business Accounting Deliberation Council (BADC) and its predecessors. The BADC was originally formed as an advisory body to the Minister of Finance (MOF), and is now an advisory body to the Prime Minister of Japan and the Commissioner of the Financial Services Agency (FSA), based on the recent restructuring of the government. More specific missions of the BADC include establishing accounting and audit standards and recommending strategic plans for domestic and international activities.

In July 2001, a new accounting standard-setting body was formed in the private sector. The Financial Accounting Standards Foundation (FASF) is a supervisory foundation, and, as an independent force, the Accounting Standards Board of Japan (ASBJ) is now working on developing Japanese GAAP. The FASF is funded mainly by the business community and public accountants. The ASBJ currently has 13 voting members, including 3 full-time members. It issues or revises accounting standards, implementation guidelines, and practice bulletins applicable to business enterprises. The Board is supported by approximately 15 staff members, most of whom are fellow members from major accounting firms and larger listed companies. The BADC has just issued accounting standards for business combination in October 2003, which was one of the accounting issues that were previously addressed before the establishment of the ASBJ, and will add no further new projects for pursuing setting accounting standards.

The ASBJ is now actively working toward developing accounting standards or implementation guidelines relating to various issues, including presentation of shareholders' equity and its changes during the period, earnings per share, stock compensation, leases, impairment of assets, business combinations and other implementation issues.

The purpose of the establishment of the ASBJ is to develop domestic accounting standards through its own independent decision making, through a distillation process of experience in

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[2] This article is based on information available as of December 2003.

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financial markets and accounting community. It also presumably includes contributing to international harmonization or convergence of accounting standards.

2.2 Financial Reporting Environment in Japan

In Japan, financial reporting is governed by two different sets of laws and regulations. The Commercial Code (CC) requires that all "merchants," including joint stock companies, must keep books and prepare balance sheets. Especially, joint stock companies must submit their accounts to the annual shareholders' meetings for their approval. The Securities and Exchange Law (SEL) requires public companies to file their consolidated and parent-only financial statements with financial regulators. Thus, public companies must prepare three sets of financial statements. Financial statements required by the CC and those required by the SEL are essentially the same, but still differ in some respects. For example, the CC does not require companies to prepare cash flow statements, while the SEL do require these from public companies. There still remain minor differences in display of financial statements, and the SEL generally requires additional extensive footnote disclosures.

In addition, the Corporate Income Tax Law and its regulations set forth comprehensive tax rules in great detail, so that financial statements prepared under the CC and the SEL are significantly influenced by the tax rules. The accounting system in Japan is comprised of three different regulations; the CC, the SEL, and the tax rules. The three components are closely tied and have affected each other. In this sense, the accounting system in Japan has been characterized as a "Triangular Legal System."

However, recent moves relating to the accounting system are generally recognized as going toward harmonization of financial statements required by the CC and the SEL. The CC recently removed their own accounting requirements, which are now moved to the ordinances of Ministry of Justice, and require that larger companies must prepare consolidated accounts, which would be identical, for public companies, to the consolidated financial statements required by the SEL and its related regulations and GAAP.

Tax laws and regulations are becoming relatively independent from accounting treatments prescribed by GAAP. Because interperiod allocations of income taxes have now been in practice since 1999, conformity between accounting earnings and taxable income has become less important.

Another important move was that the FSA amended its regulations in 2002, allowing Japanese SEC registrants to file with Japanese financial regulators their consolidated financial statements that are in accordance with U.S. GAAP. Previously, only SEC registrants that had already prepared consolidated financial statements in accordance with U.S. GAAP before Japanese regulators first required preparation of consolidated financial statements during the 1970s were allowed to file U.S. GAAP consolidated statements, while other SEC registrants

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had to prepare their consolidated financial statements in accordance with Japanese GAAP to file with Japanese regulators, even though they were preparing consolidated financial statements in accordance with U.S. GAAP for U.S. filing.

3. Summary of Comparison

This section briefly summarizes differences between Japanese GAAP and the IASs. Since it would be very difficult to assess objectively the magnitude of each difference identified, the following summary inevitably reflects the author's personal judgments as to whether specific differences should be noted in this paper. Financial statement preparers and auditors should refer to the original accounting literature written by the standard-setters.

3.1 Financial Statement Presentation

A full set of financial statements of Japan differs, depending on whether the statements are consolidated or parent-only. Parent-only, separate financial statements contain balance sheet, income statement (including section of appropriation of income by the board of directors during the period), cash flow statement, statement of appropriation of income by the shareholders' meeting, and their related schedules. A set of consolidated financial statements includes consolidated balance sheet, consolidated income statement, consolidated statement of additional paid-in capital and retained earnings, and the related schedules.

International accounting standards do not require presentation of parent-only financial statements. Types of consolidated financial statements required by the international standards are not materially different from those required by Japanese GAAP.

For income statements, differences may be identified in the presentation of extraordinary items and accounting changes. Extraordinary gains and losses generally contain non-recurring items and prior-period adjustments. Although the definition of non-recurring items by the Japanese GAAP may be literally concurrent with what are reported as extraordinary items under the international accounting standards, it includes gains and losses on sales of long-term investments in properties, equipments, real estates, and other-than-trading securities.

In Japan, income taxes are presented in a format where they are subtracted from pretax net income. Extraordinary items are presented above the pretax income, and, therefore, are presented as a pretax amount, between the ordinary income and the pretax net income.

Changes in accounting methods are generally prohibited under Japanese GAAP except when such changes are justified by supportable reasons, such as because those changes result from changes in laws and accounting standards, or because they would bring about fairer representation. However, it is generally said that entities are likely to change their accounting policies more frequently in Japan than entities that comply with international standards. In

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addition, Japanese GAAP does require disclosure about the effects of accounting changes but does not specify how accounting changes should be accounted for and how they should be presented in income statements. In practice, for example, changes in depreciation method for a fixed asset are treated prospectively; that is, any gains or losses on the adjustment are not recognized currently but deferred to be recognized over the remaining useful years through the depreciation process.

Changes in estimates are accounted for prospectively under the IASs. Japanese GAAP generally requires that prior-period adjustments should be presented currently as an extraordinary items in income statements, but does not specify what kind of changes in estimates must be treated as prior-period adjustments. In practice, any adjustment of changes in estimates of useful lives or salvage values of long-lived assets is recognized as extraordinary gains or losses during the period of adjustments.

3.2 Inventories

Accounting principles for inventories were generally established in 1949 in Japan. Since then, only minor modifications have been added to the original wording when revising the accounting principles.

IAS 2 (revised 1993), *Inventories*, allows the LIFO inventory method as an alternative method[3]. Japanese accounting standards allow entities to choose among the specific identification method, the FIFO method, the LIFO method, and the average cost method.

IAS 2 requires the lower-of-cost-or-market (LOCOM) method for valuation of inventories. Japanese GAAP allows entities to choose between the cost method and the LOCOM method. Any decline in market value, except for other-than-temporal decline, would not be reflected in financial statements under the cost method. However, even if an entity chooses the cost method, any other-than-temporary declines in market value of the inventories must be recognized, resulting in writing down the carrying amount of the inventories.

3.3 Cash Flow Statements

The Japanese accounting standard for cash flow statements is relatively new. It was issued in 1998. Previously, statements of fund flows, which presented direct inflows and outflows of cash and other short-term investments or monetary items, were attached to the financial statements filed with the then Ministry of Finance.

Formats of cash flow statements required by current Japanese GAAP are very similar to those required by IAS 7 (revised 1992), *Cash Flow Statements*. Cash flow statements in Japan

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[3] In the IASB's Improvement Project, it is currently proposed that the LIFO method be no longer allowed as an alternative method.

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have three categories; i.e., cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. Cash flows from operating activities are presented by either the direct or the indirect method.

Minor differences remain in presentation of cash receipts and payments of interest and dividends, and payments of income taxes. Japanese GAAP requires an entity to choose one of two alternative methods. If an entity chooses the first method, it must present receipts of interest and dividends and payment of interest in the category of cash flows from operating activities. Under the second method, an entity must present receipts of interest and dividends in the category of cash flows from investing activities, and payments of interest and dividends in the category of cash flows from financing activities. IAS 7 states that receipts of interest and dividends are alternatively presented in either of the categories of cash flows from operating or investing activities, and payments of interests and dividends in either of cash flows from operating or financing activities.

IAS 7 allows presentation of income taxes in the cash flows from operating activities or presentation after allocating income taxes into the three categories when such cash flows for income taxes can be specifically identified into investing and financing activities. Japanese GAAP requires the presentation of cash flow from income taxes only in the category of cash flows from operating activities.

3.4 Accounting for Income Taxes

The Japanese accounting standard for income taxes, which specifically requires recognition of deferred tax assets and liabilities on a parent-only basis, were issued in 1998. Previously, inter-period allocation for income taxes was at the entity's option when it was required to present its consolidated financial statements to be filed with the MOF since 1970s, and was required first on the consolidated financial statements in 1997 by accounting standards for consolidated financial statements.

The Japanese GAAP and the international accounting standards both adopt the asset and liability approach to accounting for income taxes. That is, both require identifying temporal taxes and applying effective tax rates to the temporary differences. Deferred tax assets would be recognized to the extent that deductible temporary differences can be collected through future taxable income.

IAS 12 (revised 2000), *Income Taxes*, requires an entity not to discount cash flows from income taxes. Japanese GAAP does not mention discounting, but it is generally understood that discounting is not an accepted practice.

3.5 Segment Reporting

The international accounting standard for segment reporting was originally set forth as

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IAS 14 (1981), *Reporting Financial Information by Segment*. IAS 14 was revised in 1997 and the title of the standard was changed to IAS 14 (revised 1997), *Disclosures about Segments of an Enterprise and Related Information*. The revised IAS 14 requires an entity to select either business segments or geographic segments as primary segments, based on the internal structure of the business entity. The other segments that are not selected as primary segments are named as secondary segments. For primary segments, IAS 14 requires extensive disclosures, including revenue, income, assets, liabilities, capital expenditures, depreciation expense, other non-cash expenses, and impairment loss. For secondary segments, it requires only limited disclosures.

The Japanese reporting standard is rather similar to the former IAS 14 (1981). It requires public companies to disclose information about both industrial and geographic segments, regardless of how the companies are organized internally. For industrial segments, operating revenue, operating income, identifiable assets, depreciation expenses, and additions to the assets should be disclosed. For geographic segments, operating revenue, operating income, and identifiable assets should be disclosed.

3.6 Property, Plant, and Equipment

Property, plant, and equipment should be measured at cost less accumulated depreciation in both the Japanese GAAP and international accounting standards.

The original cost of the asset is determined in an essentially similar way, but methods of accounting for closure and removal costs differ from each other. IAS 16 (revised 1998), *Property, Plant and Equipment*, requires that a liability that results in future cash flows for closure and removal activities should be recognized, and that accrued costs must be added to the original cost. In Japan, such future closure and removal cash flows are generally deducted from the salvage value of the asset or are recognized as a provision for closure and removal on an accrual base, which would result in allocating the cost over the useful life of the asset.

A major difference can be found in the practice of revaluation, which is an allowed alternative by IAS 16. In Japan, GAAP does not allow revaluation, but the Land Revaluation Law, which was enacted originally in 1998, gave large companies, as defined in the Commercial Code, and financial institutions a chance for one-time optional revaluation of land for operating purposes for the fiscal years ending March 1998-March 2002.

IAS 40 (2002), *Investment Property*, requires an entity to select either the cost model or the fair value model on subsequent measurement of investment properties. If the cost model is selected, fair value information about investment properties must be disclosed in the accompanying footnote to the financial statements. Japanese GAAP neither set forth a definition of investment properties for measurement purpose (but require presentation as a separate line item on the balance sheet), nor require fair value disclosure about investment

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properties. The BADC's *Accounting Standards for Impairment of Long-Lived Assets*, which was issued in August 2002, revisited the issue and stated that the BADC had decided not to require fair value information for investment properties.

3.7 Leases

In Japan, the accounting standard for leases was set forth in June 1993. The BADC's *Accounting Standard for Leases* requires an entity to identify finance leases and operating leases. Properties leased by finance leases are required, in principle, to be capitalized, and lease payments must be recognized as a liability. Properties leased by operating leases are treated as rented properties, charging lease payments to expense.

However, properties leased under finance leases that do not transfer the ownership title to the lessor at any time in the lease period may not be capitalized, provided that pro forma information about the leased properties and lease payments is disclosed in the footnotes.

Accounting for finance leases by lessees is regarded as different, because the Japanese GAAP state that sales revenue, including interest revenue, and cost of sales are proportionally recognized, on either a gross base or a net base, when periodic lease payments are received. That is, Japanese GAAP treat payments under a finance lease contract as sales revenue in installments. IAS 17 (1997), *Leases*, requires that lease payments be separated into the sales margin and the interest income at the beginning of the lease period, and that sales margin must be recognized immediately.

3.8 Revenue Recognition

Japanese GAAP demand that revenue should be recognized based on the realization principle. Although the concept of realization is not specifically defined in GAAP, it is interpreted to mean that revenue is realized if the following two conditions are met: (a) a transfer of goods or services takes place, and (b) there have been receipts of cash or cash equivalents (including accounts receivable).

Construction contracts are accounted for alternatively by the completion method or the percentage-of-completion method. Such treatment is different from IAS 11 (revised 1993), *Construction Contracts*, which requires the percentage-of-completion method when the outcome of the contract can be reliably estimated.

3.9 Post-Employment Benefits

In Japan, the BADC issued *Accounting Standard for Post-Employment Benefits* in 1998. The *Standard* requires that accrual accounting must be applied to post-employment benefits, including one-time retirement payments (unique to Japanese practice) and monthly pension payments. Previously, entities recognized provisions for one-time benefit payments, but

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pension liabilities were not recognized because contributions to pension plans were charged to expense when paid.

The basic concept of the new *Standard* applying to accounting for post-employment benefits is not materially different from IAS 19 (revised 2002), *Employee Benefits*. It requires that pension obligations be measured as projected benefit obligations, which means that any long-term inflationary trends in benefits must be reflected in the measurement. Post-employment benefit liability is measured as the excess of projected benefit obligations over pension assets, which are measured at fair value.

For allocation of projected post-employment benefit obligations over past service period and future service period, Japanese GAAP provides a choice among the straight-line method, the salary payment method, and the benefit multiplier method. IAS 19 requires that an entity must choose a method used for benefit calculation formula. Both require risk-free interest rate in discounting the accrued portion of the projected benefit obligation. Because Japanese GAAP allows the use of an average of interest rates for the past several years, in which abnormal interest rates were often excluded, the discount rates today are generally higher than the closing market interest rates.

Past-service cost must be allocated over the weighted average of remaining service years of employees under Japanese GAAP. IAS 19 require that vested past-service cost be recognized immediately, but allow entities to allocate the remaining unvested portion of past-service cost over the weighted average of remaining service years.

Adjustments of accounting changes by first-year application of a new standard must be allocated over 15 years in Japan, but 5 years under IAS 19.

IAS 19 adopts the “corridor” approach to adjusting actuarial differences, while Japanese GAAP adopt the “materiality” approach. Under the “materiality” approach, an entity can leave any difference unrecognized if the difference falls within the 10 percent materiality threshold of changes in pension assets or benefit obligations. If the difference exceeds the 10 percent materiality threshold, it must be allocated over the remaining service years.

In Japan, the excess of pension asset over benefit obligation (plus any unrecognized differences), if any, is recognized as prepaid pension costs unless the excess stems solely from increases in past-service obligation or actuarial difference.

3.10 Foreign Currency Translations

Foreign currency transactions are translated at the exchange rates as of the translations under both Japanese GAAP and IAS 21 (revised 1993), *The Effects of Changes in Foreign Exchange Rates*. It was noted as a symbolic difference that Japanese GAAP used to require applying the current exchange rates to short-term monetary assets and liabilities and historical exchange rates to long-term monetary assets and liabilities. The existing BADC’s *Accounting*

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Standard for Foreign Currency Transactions, which was revised in 1999, requires applying the current exchange rates to all monetary assets and liabilities.

Hedging instruments, including foreign currency forward contracts and other types of foreign currency derivative instruments, are accounted for in conformity with accounting standards for financial instruments. That is, hedging instruments are separately recognized as an asset or liability at fair value. The changes in fair value may be deferred if an entity adopts deferral hedge accounting. If the entity adopts mark-to-fair-value hedge accounting, the hedged assets or liabilities may be measured at fair value.

Foreign currency hedging instruments may also be accounted for by the "synthetic instrument approach." Under this approach, the hedging instrument and the hedged item are accounted for as if those instruments are a combined instrument. Under the international accounting standards, foreign currency hedging instruments are accounted for in conformity with IAS 39 (1998), *Financial Instruments: Recognition and Measurement.*

For purposes of translating foreign currency financial statements, foreign operations are categorized into (a) foreign branches (part of legal entity) and (b) foreign subsidiaries (separate legal entity). Financial statements of foreign branches should be translated by the temporal method. That is, financial statement items must be translated as if those items are a direct extension of the headquarters office. Financial statements of foreign subsidiaries should be translated by using the current rate method. All financial statement items, except for inter-company transactions, are translated at current rates or average rates.

3.11 Business Combinations

IAS 22 (revised 1998), *Business Combinations*, requires that the pooling-of-interest method should be applied to the business combinations that are categorized as the uniting of interests, and that the purchase method should be applied to the business combinations that are categorized as acquisitions.[4]

Previously, Japanese GAAP did not specify what kind of business combinations should be accounted for by the purchase method or the pooling-of-interest method. Therefore, revaluation of transferred assets and liabilities is at the combining company's option. Goodwill is generally recognized when transferred assets and liabilities are remeasured. Negative goodwill is treated as part of additional paid-in capital. Retained earnings that have been accumulated by the combined company can be transferred to the net assets of the combining company.

The BADC issued *Accounting Standard for Consolidated Financial Statements* in 1997,

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4 As is well known, the IASB is currently undertaking a project on business combinations, toward revising the existing standards to require only the purchase method for all business combinations.

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which requires that investments in subsidiaries must be accounted for as purchase transactions. That is, the assets and liabilities of subsidiaries must be remeasured at fair value as of the date of acquisition. Minority (non-controlling) interest is carried at cost or remeasured at fair value, and is presented as a separate section between the sections of liabilities and shareholders' equity.

Very recently, the BADC issued Accounting Standards for Business Combinations in October 2003, which requires the purchase method of accounting for business combinations, unless the combination meets specific criteria for applying the pooling-of-interest method. Among others, if the combination is accounted for by the pooling-of-interest method, the resulting relative ownership between combining entities should be the same.

In Japan, any goodwill must be amortized over 20 years or less. Negative goodwill must be recognized as a liability, and be amortized over 20 years or less.

3.12 Consolidated Financial Statements and Equity Method

IAS 27 (reformatted 1994), *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, utilizes the concept of control as a determinant of the scope of subsidiaries. Control is defined as the authority to make a decision on the other entity's financial and management policy, from which the entity receives economic benefits.

The BADC's *Accounting Standard for Consolidated Financial Statements* , revised in 1997, also adopts the concept of control as a determinant of subsidiaries. It states that all controlled entities are defined as subsidiaries, which must be consolidated for the parent's reporting purposes. The BADC issued additional implementation guidance for the determination of the scope of subsidiaries, which requires that if more than 40 percent of outstanding shares of an entity is purchased by the investing entity, such entity is deemed as a subsidiary unless other counter evidence exists.

Associates are defined as entities significantly influenced in their financial and management policy by the investing entity. Both standards require the investing company to account for their investments in associates by the equity method on consolidated financial statements. Japanese GAAP requires that investments in unconsolidated subsidiaries also be accounted for by the equity method, while IAS 27 requires that such investments be accounted for as available-for-sale investments in accordance with IAS 39.

3.13 Impairment of Long-Lived Assets

In Japan, the BADC issued *Accounting Standard for Impairment of Long-Lived Assets* in August 2002[5]. This Japanese *Standard* and IAS 36 (1998), *Impairment of Assets*, both set

[5] This Standard will be fully effective for fiscal years ending on or after March 31, 2005. Earlier applications are allowed for fiscal years ending during March 31, 2003 to March 30, 2005.

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forth procedures that require companies to take similar steps, including identification of impairment indicators, performing recognition tests, and measuring impairment losses.

The major difference can be found in recognition criteria. IAS 36 says that if the carrying amount of the asset in question exceeds the collectible amount (defined as the higher of value in use or net selling price), an impairment loss must be recognized. Japanese GAAP, which are rather similar to the U.S. GAAP regarding recognition criteria, state that if the carrying amount exceeds the undiscounted sum of future cash flows from continuous use and eventual disposal of the asset, an impairment loss must be recognized. Japanese GAAP are based on a belief that an impairment is an irreversible event and an impairment loss must be recognized only when such impairment has a high degree of certainty of existence, because estimates of future cash flows are highly subjective.

Another difference is related to restoration. IAS 36 requires recognition of a restoration of the asset that meets certain criteria for restoration. Japanese GAAP, like U.S. GAAP, prohibit any restoration.

In determining future cash flows, Japanese GAAP state that only cash flows based on plans for future events committed by the management must be incorporated into the estimation. IAS 36 prohibits the inclusion of cash flows from future events, including future capital expenditures and future restructuring, in determination of recoverable amount.

Treatment of corporate assets is also different. IAS 36 requires that if an impairment loss is recognized in a cash generating unit, a proportionate portion of the carrying amount of corporate assets attributable to the units must be subject to recognition of an additional impairment loss for corporate assets. Japanese GAAP require applying either the IAS 36 method or the U.S. GAAP method. Under the U.S. GAAP method, an entity is required to set forth a higher level grouping of assets, in which additional impairment may be recognized attributable to corporate assets.

3.14 Provisions and Contingency

In IAS 37 (1998), *Provisions, Contingent Liabilities and Contingent Assets,* provisions are built on the definitions of liabilities. Uncertainty in amount and timing of future cash outflows involves recognition of provisions. The definition of provisions includes constructive obligations as well as legal obligations.

In Japan, recognition criteria for provisions were set forth based on the revenue and expense approach. This approach allows entities to recognize liabilities that are not legal obligations, such as provisions for bad debt loans and provisions for future asset-maintenance expenditures. Japanese GAAP sets forth the following criteria; (a) future outflows of cash and other resources are identified, (b) the outflows occur as a result of the events during current or past accounting periods, (c) it is probable that such outflows will occur, and (d) the outflows

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are measurable with reliability. Those criteria are generally consistent with recognition criteria prescribed by IAS 37.

If it is not probable that future outflows of resources will occur, contingent liabilities are not recognized under Japanese GAAP. Such treatment is not inconsistent with IAS 37, which states that a contingent liability is not recognized if future outflow of resources is not probable to occur or if it is not measurable with reliability. However, interpretation about the "probability" criterion in both standards does not look similar. Japanese GAAP (literally translated into English) generally require that to be recognized in the balance sheet it must be "highly probable."

3.15 Intangible Assets

In Japan, the BADC issued *Accounting Standard for Research and Development Costs* in 1998. The *Standard* states that research and development costs should be charged to expense immediately they are paid. This treatment is identical to that of the U.S. GAAP. IAS 38 (1998), *Intangible Assets*, requires that research costs be charged to expense immediately, but that development costs can be recognized as assets if certain criteria are met. Software production costs are recognized in Japan, depending on how the software will be used, unless they meet the definition of research and development costs.

IAS 38 and Japanese GAAP both require that intangible assets must be amortized over their useful lives and must be reviewed as to whether they are impaired when events indicate that any impairment might exist for such assets. In Japan, useful lives for amortization of intangible assets that are prescribed by tax laws are generally also used for financial reporting purposes.

3.16 Financial Instruments

In Japan, the BADC issued *Accounting Standard for Financial Instruments* in 1999. The BADC's *Standard* and IAS 39 (revised 2000), *Financial Instruments: Recognition and Measurement,* both establish a comprehensive set of standards for various aspects of accounting for financial instruments. IAS 32 (revised 1998), *Financial Instruments: Disclosure and Presentation,* sets forth requirements for disclosure and presentation of financial instruments.

Japanese GAAP and IAS 39 both state that a financial asset or financial liability must be recognized when parties are agreed on a contract that gives one party a right to receive cash or other financial assets and imposes on the other party an obligation to pay cash or other financial assets. Both also adopt the "financial-component approach" to derecognition of financial assets and liabilities.

As for subsequent measurement of financial assets, Japanese GAAP provide different

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measurement methods for loans, securities, and derivatives. They state that loans must be carried at the face amount or amortized cost. Japanese GAAP categorize investments in securities into four categories; (a) securities held for trading purposes, (b) equity investments in subsidiaries and affiliates, (c) debt securities held to maturities, and (d) others. Trading securities must be marked to market with recognizing changes in fair value in net income. Equity investments in subsidiaries and affiliates must be carried at cost on the parent-only financial statements unless the fair value declines significantly below the cost. Debt securities held to maturity must be carried at amortized cost. Amortization is based on either the interest method or the straight-line method. "Other" securities, which would be categorized as "available-for-sale" investments under IAS 39, must be carried at fair value in the balance sheet. Resulting increases in fair value from remeasurement of "other" securities, net of tax, are presented as a separate component of shareholders' equity. Resulting losses are presented as a separate component of equity or included in net income.

IAS 39 identifies all financial assets into four categories; (a) financial assets held for trading, (b) financial assets held to maturity, (c) loans originated, and (d) financial assets available for sale. Although such categorization is different, measurement methods required by IAS 39 generally concur with those required by Japanese GAAP. However, several minor differences can be identified. For example, as for available-for-sale financial instruments (compared with "other" securities under Japanese GAAP), IAS 39 allows entities to recognize changes in fair value in net income. The Japanese GAAP require entities to recognize gains in equity, but give them a choice to recognize losses in equity or in net income. Japanese GAAP also allow the average of fair value during the closing month of the fiscal year. As for restoration of the value of loans, IAS 39 requires restoration, but Japanese GAAP do not allow restoration.

As for financial liabilities (except for obligations resulting from derivative instruments), IAS 39 requires application of the amortized cost method to subsequent measurement of financial liabilities, while Japanese GAAP require measurement of those financial liabilities at face amount. Under the Japanese GAAP, if an entity issues bonds for the amount less than the face amount, the discount would be recognized as an asset (like prepaid interest). Such discount asset would be amortized by the straight-line method.

Derivative financial instruments are generally measured at fair value in the balance sheet under both IAS and Japanese GAAP. As for interest rate swaps and forward foreign exchange contracts, which are frequently-used instruments in practice, Japanese GAAP provide some exception to fair value measurement of derivative instruments. Japanese GAAP allow accrual accounting to "plain-vanilla" interest rate swaps that are held for hedging interest-bearing financial assets or liabilities that have essentially the same duration. They also allow entities to adopt the "synthetic instrument approach," as discussed earlier, to forward foreign

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exchange contracts that hedge foreign currency risk exposures.

Japanese GAAP also give entities an option to adopt either deferral hedge accounting and mark-to-market hedge accounting. If deferral hedge accounting is adopted, deferred gains and losses on hedging instruments are carried as an asset or liability in the balance sheet. IAS 39 states that if exposures to the volatility of fair value of the existing assets and liabilities and firm commitments are hedged (fair value hedge), an entity may accelerate recognition of changes in fair value on hedged items whereas the hedging instruments are measured at fair value with recognizing changes in fair value through net income. If exposures to the volatility of future cash flows of anticipated transactions, entities may defer changes in fair value on hedging instruments in the shareholders' equity, rather than as an asset or a liability.

As for combined financial instruments, Japanese GAAP generally apply a separate accounting to bonds with warrants and convertible bonds. Undetachable bonds with warrants and convertible bonds are now termed as bonds with put options, according to the 2001 amendment to the Commercial Code. As for bonds with put options that require holders to substitute the amount redeemed at the exercise of the put option as the payment at the issuance of the new stock (previously referred to as convertible bonds), an issuer may or may not adopt separate accounting. If it does not adopt such accounting, bonds with put options, as a whole, would be presented as a liability section in the balance sheet.

4. Analysis of Differences between IAS and Japanese GAAP

The historical moment for international harmonization of Japanese GAAP with internationally accepted accounting standards was the 1996 instruction by the Prime Minister Ryutaro Hashimoto to related Council chairpersons formed in the Ministry of Finance. The objective of the instruction was to reform the financial system (banking, capital market, foreign currency market, and others) so as to achieve establishment of a "free, fair, and global" market.

In the accounting community, the instruction has been implemented into a series of establishments and amendments of accounting standards, including amendments to accounting standards for consolidated financial statements and for foreign currency translations, and establishments of new accounting standards for cash flow statements, research and development costs, income taxes, post-employment benefits, and financial instruments. The reform, referred to as the "Accounting Big Bang," has been received as an ongoing project. Recently issued accounting standard for impairment of assets is an outcome of the reform, and the BADC still have another project on accounting for business combinations and goodwill.

In developing accounting standards that have been issued or amended since the 1996

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instruction in Japan, every issue has been discussed from a standpoint of international harmonization or convergence. Therefore, it can be said that such accounting standards are generally well harmonized with IAS or U.S. GAAP. On the other hand, Japanese accounting standards that were already issued before the 1996 instruction have many significant differences from international accounting standards.

Therefore, we can say that establishing or revising accounting standards since the 1996 instruction provides a "clearing" process for international harmonization. As for accounting standards that were already issued before the 1996 instructions, it would be important to identify differences from international standards because such differences have not yet been discussed from an international viewpoint. In Japan, various analyses and comparisons from an international viewpoint are still going on, and such tasks would assist standard-setters in identifying the issues to be discussed in the international context, and, consequently, would bring benefits to related parties in Japan from international harmonization.

As for the current topics being discussed in the international arena, most of the new agenda projects undertaken by the IASB had not been dealt with by Japanese standard-setters. Such IASB agenda projects are now conducted in cooperation with other national accounting-setting bodies. Japanese accounting-setters would gain more benefits if they dealt with those agenda projects in corporation with the IASB and other national accounting standard-setters, and such a movement is now being implemented.

For the accounting standards that have been issued after the 1996 instruction in Japan, there still remain differences from the international accounting standards, even though those standards are reviewed from the international viewpoint. We have analyzed such differences, and identified the reasons why those differences may arise: (a) because Japanese accounting standard-setters believe that other alternatives that are not allowed by IAS would provide more useful information to users, (b) because there are some differences in the regulatory or statutory environment in the jurisdiction, and (c) because differences in other parts of GAAP may create additional significant inconsistency between the existing accounting standards and the proposed standards that are consistent with IAS.

If the reason producing a difference is (a) above, it would be important that Japanese accounting standard-setters communicate with the IASB or other accounting standard-setters to discuss the possibility of adopting the Japanese proposal as an internationally accepted alternative. If the differences are emerging because of reason (b) above, it seems to us that the international standards may not provide for international prevalence that can be applied in specific jurisdictions, while it would be also important that Japanese standard-setters attempt to eliminate such obstacles toward international convergence.

Differences that have arisen from reason (c) above are sometimes observed in Japan, which indicate that it is necessary to initiate an overhaul project across individual standards.

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The differences stem from avoiding inconsistency in the accounting literature in Japan. It would be important to recognize that such a piecemeal approach to standard-setting would continue to create other conflicts within the accounting literature. As many have requested, undertaking a conceptual framework project or a literature "inventory" project would be an efficient approach to eliminating such types of difference.

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