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Institutions and accounting standard transformation: Observations from Japan

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ABSTRACT

This paper describes the transformation of Japan's accounting standards over the past 2 decades and the driving forces behind this transformation. It also analyzes the current state of Japan's accounting standards, which are characterized by the dichotomy of accounting systems inherited from the country's political, economic and legal institutions. The discussion in this paper emphasizes that a single set of accounting standards is not always effective for every entity.

1. Introduction

The economic downturn that began in 1991 after the collapse of the Japanese Asset Price Bubble is referred to as the Lost 10 years, a period that has also been thought to extend to the recent decade (2001–2010). During these 2 decades, Japanese accounting systems drastically changed to help restart the Japanese economy based on government policy. The necessity of the financial system reform is emphasized in the *Financial System Reform* (Ministry of Finance, 1997) report as follows.

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> "In the 'aging' society of the 21st century, in order to ensure the continuation of Japan's economic vitality, it is necessary to find a more efficient way of investing private assets which reach up to 1200 trillion yen. It is important to provide funds for the developing industries that carry the coming era on their shoulders. Further, to make a contribution to international society commensurate with its economic strength, it is imperative that Japan provides a smooth supply of funds for the world."[1]

With a view to reconstructing Japan's financial markets to make them internationally competitive and comparable with those in New York and London, the financial system was rapidly reformed according to three principles: "free" to ensure a free market that implemented market principles, "fair" to ensure a transparent, trustworthy market and "global" to ensure an international market that was ahead of its time (Ministry of Finance, 1997). Transforming the accounting standards was a reform effort made to regenerate the vitality of Japan's financial markets. Due to this effort, Japan's accounting standards are currently considered to be at a level similar to those of the West (Saito, 2011).

This paper describes the transformation of Japan's accounting standards over the past 2 decades and the driving forces behind this transformation. It also analyzes the current state of Japan's accounting standards, which are characterized by the dichotomy of accounting systems inherited from the country's political, economic and legal institutions. The discussion in this paper emphasizes that a single set of accounting standards is not always effective for every entity.

2. Effects of financial liberalization and globalization on the equity finance of Japanese listed companies

The progress of financial liberalization and globalization since the 1980s has caused the financial service sector to develop rapidly and, as a result, the performance of the financial economy began to drive economic fluctuations that were previously driven by the real economy (Ogawa and Kitasaka, 1998). Due to the circumstances characterizing the last 20 years of the 20th century, deregulation of the Japanese financial system changed the financing method of Japanese listed companies from indirect to direct. The deregulation policy previously described is cited as the Japanese version of the "Big Bang," which was successfully conducted a decade earlier in the United Kingdom. The change that Japanese accounting systems have undergone since 1997 is commonly referred to as the "Accounting Big Bang."

Fig. 1 depicts the trends of the financial assets, financial liabilities and equity ratios of companies across 33 industries, excluding banks listed on the Tokyo Stock Exchange and the Osaka Stock Exchange from 1985 to 2001.[2] The equity ratio increased from 28.5% in 1985 to 42.2% in 2001. Consistent with this trend, the financial liabilities ratio decreased from 57.2% in 1985 to 45.9% in 2001. The upward change in the equity ratio reflects that management chose equity finance instead of debt finance by considering the merits of capital costs according to the circumstances of financial liberalization and globalization.

In addition to these trends, the financial assets ratio did not change significantly from 1985 to 2001. However, the ratio was higher than 56% during the period and reached 61.8% in 1990 during the bubble economy. According to the relatively high ratio of financial assets to total assets of Japanese listed companies, the valuation of financial assets was considered an important issue for investors to make informed economic decisions. The data did not include information on the appreciation of marketable securities for trading purposes and investments in mutual-holding securities among business partners. The more important issues

[1] The financial system reform was initiated by Prime Minister Hashimoto in November 1996. The Securities and Exchange Council, the Business Accounting Council (BAC), the Financial System Research Council, the Insurance Council and the Committee on Foreign Exchange and Other Transactions began formulating a plan for reform measures to be completed by 2001. To promote the reform process as a unified scheme, a "Financial System Reform Consultative Committee" consisting of representatives from each of the councils was set up to discuss the issues crossing each council's scope (Ministry of Finance, 1997).

[2] The reporting periods for the companies in the sample end in March of each year. The sample includes the following figures (year, sample/total number of listed companies, sample %): 1985, 961/1,864, 51.6%; 1986, 993/1,922, 51,7%; 1987, 1,089/2,015, 54.0%; 1988, 1,257/1,961, 64.1%; 1989, 1,431/2,004, 71.4%; 1990, 1,525/2,049, 74.4%; 1991, 1,589/2,093, 75.9%; 1992, 1,639/2,125, 77.1%; 1993, 1,677/2,160, 77.6%; 1994, 1,701/2,187, 77.8%; 1995, 1,743/2,225, 78.3%; 1996, 1,767/2,250, 78.5%; 1997, 1,792/2,253, 79.5%; 1998, 1,800/2,254, 79.8%; 1999, 1,804/2,254, 80.0%; 2000, 1,804/2,254, 80.0%; 2001, 1,807/2,255, 80.1%.

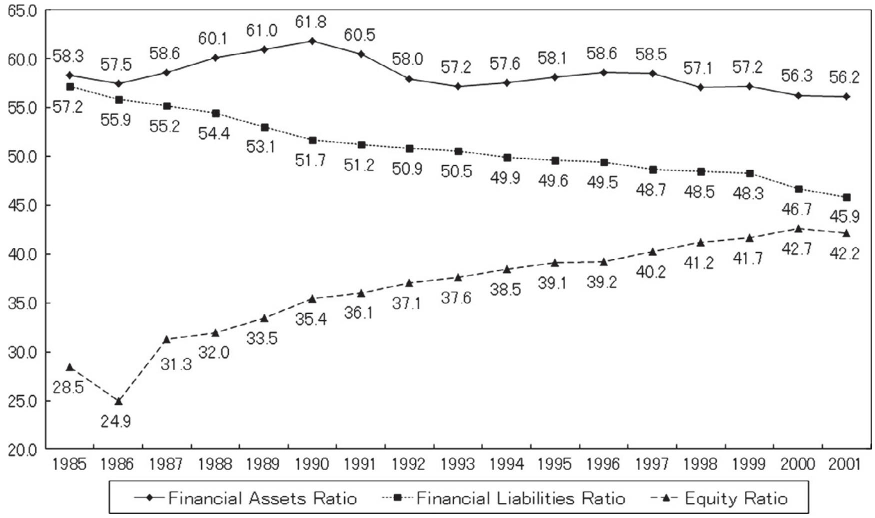

Figure 1. Trends of financial assets, financial liabilities and equity ratios. *Source:* Urasaki, 2002, cf. Chapter 2.

were the recognition and measurement of financial derivatives,[3] which financial performance did not cover in the data due to a lack of accounting standards. Hence, investors did not have enough information related to the results of Japanese listed companies' financial risk management.

Table 1 shows the financial ratios relevant to the financial assets of Japanese listed companies in 1998 and 2001.[4] The Business Accounting Council[5] (BAC) issued accounting standards for financial instruments in 1999. These standards require companies to make mark-to-mark valuations of certain securities and hedge accounting to indicate their financial risk management performance for the reporting period ending March 2001.

The securities held for trading purposes are classified as current assets and require mark-to-market valuations with immediate profit recognition. The securities-held-for-trading ratio refers to the ratio of securities to total assets. This ratio indicates a remarkable change from 1998 to 2001. The ratios of every industry except for the communication industry decreased due to several factors. Management might have simply chosen not to indicate the appreciation of their securities. Further, they could have been making an effort to avoid increases in their taxable income or control their reporting earnings. The pulp and paper, rubber, steel, non-ferrous metals, shipbuilding and marine transportation industries showed rate decreases of over 70% in 2001. To the contrary, investment securities classified as non-current assets increase in most industries. This change means that management intentionally transferred securities classified as current assets to non-current assets because the investment securities did not require appreciation by mark-to-market valuation.

In addition to the management behavior related to holding securities, the average rate of the financial assets ratio of the 33 industries is 56.2%, and nearly 60% if real estate, gas, railway/bus and electricity rates are excluded. By comparing the average rate of the depreciable tangible assets ratio (17.1%) among the industries, the relative significance of the financial assets to total assets can be recognized. The financial assets ratios of

[3] The turning point in the transformation of Japanese accounting standards into those relying on the substance-over-form principle was the issuance of accounting standards for financial instruments set by the BAC in 1999. The standards introduced mark-to-market valuation with immediate profit recognition for securities held for trading, valuation without immediate profit recognition for those not held for trading, devaluation for loans receivables and hedge accounting procedures (Saito, 2011, p. 191).

[4] The 1998 ratios were calculated based on the financial data of 1,800 listed companies reported from April 1997 to March 1998. The ratios in 2001 were calculated based on the data of 1807 listed companies reported from April 2000 to March 2001. Industries were classified according to the Nikkei Economic Electronic Databank System (NEEDS).

[5] The BAC is one of the councils set by the Financial Service Agency. It consists of a Planning and Coordination Committee, an Internal Control Committee and an Audit Committee. Before organizing the Accounting Standards Board of Japan in 2001, the council played a major role in setting accounting standards. The council currently issues auditing and internal control standards.

Table 1
Relevant financial ratios of Japanese listed companies in 1998 and 2001. *Source:* Urasaki, 2002, cf. Chapter 2.

	Financial assets ratio		Securities held for trading ratio		Investment securities ratio		Depreciable tangible assets ratio	
	1998	2001	1998	2001	1998	2001	1998	2001
1. Fisheries	60.3	58.9	8.2	7.4	15.0	15.9	7.2	11.5
2. Mining	52.4	56.1	4.9	1.5	7.7	16.4	13.6	12.8
3. Construction	60.4	60.5	4.7	1.8	5.4	8.9	6.7	6.3
4. Foods	54.0	54.3	6.2	2.6	11.9	17.3	21.2	19.8
5. Textile	58.8	57.2	7.2	2.5	12.9	19.2	19.5	19.5
6. Pulp and paper	39.4	41.7	5.3	0.2	7.1	10.9	22.3	36.5
7. Chemical	57.2	56.8	6.6	2.2	12.9	17.1	22.3	20.9
8. Medical and pharmaceutical	66.4	66.2	9.8	7.7	8.7	15.6	15.6	13.2
9. Petroleum	59.2	58.4	5.0	2.5	10.1	12.0	16.0	14.1
10. Rubber	57.9	58.4	3.1	0.1	13.8	17.9	26.1	23.1
11. Ceramic	55.0	56.6	5.4	2.1	13.1	18.1	24.5	22.9
12. Steel	44.8	43.2	7.3	2.0	7.5	13.2	32.4	29.5
13. Nonferrous metals	57.7	53.4	7.3	1.2	11.3	15.6	19.1	18.4
14. Machineries	62.1	60.4	8.5	2.5	11.6	16.5	13.9	13.1
15. Electronic equipment	67.1	65.9	7.6	3.5	13.1	17.0	13.9	12.7
16. Ship building	45.5	43.1	10.2	2.5	6.6	12.9	14.5	14.7
17. Motors	55.7	56.3	6.4	3.1	15.6	20.5	25.8	23.4
18. Other transportation machines	57.1	58.1	7.6	2.4	6.6	12.8	19.9	18.6
19. Precision machineries	61.5	59.5	6.5	2.9	12.7	14.6	14.5	12.1
20. Other manufacturing	58.3	58.3	3.1	2.4	11.6	12.1	18.8	15.7
21. Trading	73.1	71.9	5.6	2.0	8.3	12.4	7.4	7.2
22. Retailing	50.6	48.9	5.2	2.1	5.5	6.6	17.0	15.9
23. Other financing service	79.4	80.6	1.0	0.8	1.5	3.5	11.3	14.1
24. Real estate	27.4	27.0	2.5	0.9	5.1	8.1	23.2	22.2
25. Railway and bus	17.2	17.9	1.7	0.5	6.9	10.5	44.5	43.3
26. Land transportation	49.5	45.5	7.8	3.0	8.0	11.4	27.9	24.9
27. Marine transportation	53.6	63.0	7.5	1.2	17.9	21.7	34.2	24.7
28. Air transportation	47.7	47.2	3.0	1.9	11.6	10.9	27.0	29.4
29. Warehouse	42.8	44.8	3.7	1.3	8.0	17.6	37.6	35.1
30. Communication	36.6	54.1	5.1	7.1	6.2	22.4	38.8	26.4
31. Electricity	6.5	8.2	0.1	0.0	2.4	4.2	68.7	67.7
32. Gas	21.4	24.5	0.6	0.0	5.7	11.5	49.7	50.3
33. Services	61.1	61.2	8.0	4.1	12.3	14.4	18.1	14.3

almost one third of industries reaches over 60%. Even in the manufacturing industry, some companies such as Sony Corporation and Panasonic have rates over 80%. For example, among the 137 companies in the electronic equipment industry, the rates of 48 companies (51.8% of 137) are over 70%, and the rates of 13 companies (9.5% of 137) are over 80%.

In accordance with the financial statement data taken from Japanese listed companies, financial asset valuation is becoming a major issue for modern corporate accounting practices to recognize an entity's economic substance. As previously described, the core principles involved in recognizing and measuring traditional accounting standards[6] are historical cost, realization and conservatism. In other words, the revenue and expense views of income determination underpin traditional corporate accounting practices in Japan.

[6] The accounting principles for business enterprises were established in 1949. These accounting standards were amended several times upon promulgations of the development of the Japanese economy. However, the core concepts related to income determination have not changed due to the consistency and durability of the logic upon which the accounting principles are based. Takeda (2008) demonstrates systematically that these accounting principles were built up as an accounting theory to determine a periodic income based on revenues and expenses, known as the revenue and expense approach. He also clarifies that the accounting postulates underpinning the accounting principles could be constructed in three ways.

3. International convergence of Japanese GAAP

Saito (2011, p. 191) points out that the historical cost method made dubious accounting practices possible, including the much-criticized arbitrary realization of capital gains on securities, which were intended to camouflage business results. In the 1990s, a lot of criticism was directed toward the inadequacy of the principles involved in recognizing and measuring the financial instruments used in active financial risk management. In addition to this debate, two other direct factors stimulated the standard setters to fix new rules for financial instruments:

(1) The deregulation policy of the Japanese government related to the financial system since 1997.
(2) The external pressure of harmonizing Japanese accounting standards with International Financial Reporting Standards (IFRSs) for cross-border financing.

In January 1999, the BAC issued accounting standards for financial instruments. These standards became operative for financial statements covering periods beginning on or after April 1, 2000. The standards for financial instruments require that securities held for trading purposes and derivatives should be measured at their fair values and that gains and losses should be recognized in financial statements. Reviewing the recognition and measurement of financial instruments, the standards introduced asset and liability views of income determination into Japanese accounting practice. The milestones in the progress toward reporting financial instruments at fair value are indicated as follows. Table 2 summarizes the measurement bases of the financial instruments.

- 1985 JICPA, Accounting for Futures.
- 1990 BAC, Opinion on Accounting Standards for Futures and Options Contracts.
- 1996 Amendments of Banking Law and Securities and Exchange Law, Requirements of fair value accounting for trading securities held by financial institutions.
- 1997 BAC, Issues on Accounting Standards for Financial Instruments.
- 1998 BAC, Opinion on Setting of Accounting Standards for Financial Instruments, ED.
- 1999 BAC, Accounting Standards for Financial Instruments.
- 2000 JICPA, Guidelines on Accounting for Financial Instruments.

Japanese GAAP currently consists of accounting standards and implementation guidance on the accounting standards or practical solutions issued by the Accounting Standards Board of Japan (ASBJ).

Table 2
Measurement bases of financial instruments.

Types of financial assets		Measures	Presentation of gains
Securities	Trading securities	Market value[a]	Income Statement
	Held-to-maturity debt securities	Amortized cost[b]	N/A
	Equity investments in subsidiaries and associates	Historical cost	N/A
	Other securities	Market value	Shareholder's Equity
Receivables		Amortized cost	N/A
Monetary trust funds held for investment purposes		Market value	Income statement
Derivatives		Market value	Income statement

[a] Market value signifies fair value, which represents amounts that are based on prices, quotes and indices formed in the marketplace. If market prices are not available, fair value should be the amount that is reasonably calculated.
[b] The amortized cost method is a method by which, if receivables or debt securities are acquired at lower or higher prices than the contractual or face amount, the differences are allocated over the periods of settlement or maturity on a predetermined basis, with the allocated amounts adjusted to the carrying amounts on the balance sheet. When this method is applied, the allocated amounts are included in the interest income.

Table 3
List of Accounting Standards of the Accounting Standards Board of Japan. *Source:* Koga and Yao, 2011, pp. 7–8, the ASBJ website (https://www.asb.or.jp/asb/top.do).

ASBJ Accounting standards		Date of issue or revision
No. 1	Treasury stock and appropriation of legal reserve	11 August 2006
No. 2	Earnings per share	30 June 2010
No. 3	Retirement benefits (Part 1)	3 March 2005
No. 4	Director's bonus	29 November 2005
No. 5	Presentation of net assets in the balance sheet	27 March 2009
No. 6	Statement of changes in net assets	30 June 2010
No. 7	Business divestures and similar transactions	26 December 2008
No. 8	Stock option and other share-based payment	26 December 2008
No. 9	Measurement of inventories	26 September 2008
No. 10	Financial instruments	10 March 2008
No. 11	Related party disclosures	26 December 2008
No. 12	Quarterly financial statements	25 March 2011
No. 13	Lease transactions	30 March 2007
No. 14	Retirement benefits (Part 2)	15 May 2007
No. 15	Construction contracts	27 December 2007
No. 16	Equity method of accounting	26 December 2008
No. 17	Disclosure about segments of an enterprise and related information	30 June 2010
No. 18	Assets retirement obligations	31 March 2008
No. 19	Retirement benefits (Part 3)	31 July 2008
No. 20	Investment and rental property	25 March 2011
No. 21	Business combinations and related matters	26 December 2008
No. 22	Consolidated financial statements	25 March 2011
No. 23	Research and development costs	26 December 2008
No. 24	Accounting changes and error corrections	4 December 2009
No. 25	Presentation of comprehensive income	30 June 2010
No. 26	Retirement benefits (Part 4)	17 May 2012

The accounting and reporting standards also include the accounting standards set by the BAC (cf. footnote 5) and practical guidelines issued by the Japanese Institute of Certified Public Accountants (Koga and Yao, 2011, p. 3). The ASBJ is organized as a private institution to make Japanese accounting standards more consistent with those of other major countries and thereby facilitate Japan's participation in the IASB (Saito, 2011, p. 194).

In the 1990s, the Committee of European Securities Regulators completed its equivalence assessment of the Japanese GAAP with IFRSs in accordance with the mandate of the European Commission. The committee proposed that the commission consider that Japanese GAAP could be assessed as equivalent to IFRS, subject to the remedies of additional disclosures (Koga and Yao, 2011, p. 6). In August 2007, the ASBJ and IASB jointly announced the Tokyo Agreement to accelerate convergence between Japanese GAAP and IFRS. The agreement stated that the remaining differences would be removed on or before June 30, 2011 (Koga and Yao, 2011, p. 6).

In December 2009, the Japanese Financial Service Agency revised the ordinances to allow Japanese listed companies satisfying certain criteria to prepare consolidated financial statements according to IFRS from their fiscal years ending 31 March 2010. The ASBJ and IASB agreed that they should continue the convergence effort and establish a closer relationship. Hence, Japanese GAAP will continue being developing (Koga and Yao, 2011, p. 6). Table 3 presents a list of accounting standards released by the ASBJ. The accounting standard for financial instruments issued by the BAC in 1999 has been amended to the ASBJ accounting standard No. 10. Table 4 shows a list of the implementation guidance on ASBJ accounting standards.

Table 4
List of implementation guidance on Accounting Standards from the Accounting Standards Board of Japan. *Source:* Koga and Yao, 2011, pp. 8–10, the ASBJ website (https://www.asb.or.jp/asb/top.do).

ASBJ implementation guidance		Date of issue or revision
No. 1	Accounting for the Transfer between Retirement Benefit Plans	11 August 2002
No. 2	Treasury Stock and Appropriation of Legal Reserve	11 August 2006
No. 3	Accounting for Shareholders who Received Dividends Resulting from the Distribution of Other Capital Surplus	27 December 2005
No. 4	Earnings Per Share	25 March 2011
No. 5	[Deleted]	
No. 6	Impairment of Fixed Assets	27 March 2009
No. 7	Retirement Benefits (Part 1)	16 March 2009
No. 8	Presentation of Net Assets in the Balance Sheet	27 March 2009
No. 9	Statement of Changes in Net Assets	30 June 2010
No. 10	Business Combinations and Business Divestures	26 December 2008
No. 11	Stock Option and Other Share-based Payment	31 May 2006
No. 12	Accounting for Other Compound Financial Instruments	30 March 2006
No. 13	Related Party Disclosures	30 March 2007
No. 14	Quarterly Financial Statements	25 March 2011
No. 15	Disclosure about Certain Special Purpose Entities	25 March 2011
No. 16	Lease Transactions	26 December 2008
No. 17	Accounting for Compound Financial Instruments with an Option to Increase Paid-in Capital	25 April 2007
No. 18	Construction Contracts	27 December 2007
No. 19	Disclosure of Fair Value of Financial Instruments	25 March 2011
No. 20	Disclosure of Segment Information and Other Related Information	21 March 2008
No. 21	Assets Retirement Obligation	26 December 2008
No. 22	Determination of the Scope of Consolidated Subsidiaries and Associates	25 March 2007
No. 23	Disclosure of Fair Value of Investment and Rental Party	28 November 2008
No. 24	Accounting Changes and Error Corrections	4 December 2009
No. 25	Retirement Benefits (Part 4)	17 May 2012

4. Financial reporting and regulations

Government and bureaucratic dominance and statutory control are primary features of Japan's corporate disclosure regulations.[7] The responsibility for regulations vests in governmental departments, including the Ministry of Justice, the Ministry of Finance and the Financial Service Agency, which separated from the Ministry of Finance in 1998. The Ministry of Justice regulates the disclosures of Japanese corporations through the 2005 Corporate Law, which was reformed from the Commercial Code 1899 as amended. The Ministry of Finance regulates disclosures through the 2001 Financial Instruments and Exchange Act that was promulgated by revising the Securities and Exchange Law 1947 as amended. The Act applies to every listed corporation. The Corporate Law and the Financial Instruments and Exchange Act are accompanied by ministerial ordinances that specify disclosure requirements in detail. Through the Financial Instruments and Exchange Act, the Financial Service Agency also closely controls the operations of the Japanese stock exchanges and licensed securities companies.

[7] Bureaucratic dominance and statutory control over the regulation system are entirely consistent with and illustrative of the cultural characteristics of high power distance and high uncertainty avoidance. These characteristics are designed to remove ambiguity and uncertainty from the regulation system. Hofstede (1984, p. 159; 2001, p. 152) classifies Japan as a low individualist nation with moderate to high levels of power distance and high uncertainty avoidance. Japan's ranking as a low individualist country is consistent with the widely recognized "group consciousness" of Japanese society. Its moderate to high power distance is consistent with the importance of relative rank related to Japan's fixed social positions and with the Japanese belief in the moral basis of government. These norms and values are realized in a greater level of active involvement of the Diet (the Japanese Parliament) and bureaucracy in every area of social and economic policy formulation and administration in Japan compared with Anglo-American nations (Harrison and McKinnon. 1986. p. 243). Its high uncertainty avoidance ranking is also broadly consistent with the pattern of interpersonal relations in Japan. Social order is clearly established and defined through group membership and rank. The country places an emphasis on particularistic relations rather than universal ethics, producing a very detailed set of situational codes of conduct that are meticulously observed (McKinnon, 1986, p. 88).

As already mentioned, corporate accounting and reporting in Japan are tightly regulated by the Corporate Law, the Financial Instruments and Exchange Act and the Corporate Income Tax Law. Each Law has its own purpose. The Corporate Law aims to protect the interests of creditors due to shareholders' limited liability, and the Financial Instruments and Exchange Act seeks to protect the interests of investors. The Corporate Income Tax Law purports to compute a fair taxation base in conjunction with national fiscal policies.

The following three corporate accounting objectives are commonly accepted in light of the purposes of the Act and Laws:

(1) to ascertain the degree to which the stewardship function of management is performed for business entities;
(2) to compute the disposable income of business entities (an amount available for dividends and corporate income tax) and
(3) to provide useful information for investment decision making by shareholders and creditors.

The Corporate Law prescribes objectives (1) and (2) for the purpose of creditor protection. The Financial Instruments and Exchange Act considers objectives (1) and (3) important for investors. The Corporate Income Tax Law follows objective (2). The Act and Laws implement specific corporate accounting requirements to achieve their objectives.

Objective (2) is of primary concern to shareholders and management in view of the growth and development of business entities. However, the percentage of individual shareholders in the Japanese stock market has been relatively low due to the cross-ownership of corporations and the power of institutional investors. Hence, management attitudes toward disclosure have related to large institutional investors. Consequently, the interests or informational needs of investors, who do not have the authority to require business entities to obtain necessary information, are not always satisfied by these entities' disclosures.

Needless to say, one of the basic concepts behind accounting objectives is the influence of accounting on the national economy. This concept exists implicitly and persistently. It is specified in the Financial Instruments and Exchange Act and the original 1949 proposal for setting the Business Accounting Principles, which state that accounting standards and laws should eventually contribute to the development of Japan's national economy as a whole. In the future, corporate accounting and reporting in Japan will be developed to provide useful information for the microeconomic investment decisions made by shareholders and creditors.

Standard setting in Japan has also been dominated by the government. Accounting standards are formulated by the BAC, which is a deliberative council attached to the Financial Service Agency. Representation on the BAC is broad, mainly comprising representatives from Japanese academia, the Japanese Institute of Certified Public Accountants (JICPA),[8] the Japanese Stock Exchange and Keidanren (the representative body of large corporations). However, as noted, the responsibility for setting accounting standards has been moved from a government body to a private sector organization. Although some of the old accounting standards not shown in Table 3 are still effective,[9] the ASBJ has advanced many new accounting standards to replace the old standards or amended some of the existing standards to deal with new accounting events and converge with IFRS (Koga and Yao, 2011, p. 5).

As the managers of listed and unlisted stock companies, directors are required to make accounting records of business transactions and prepare financial statements (referred to in the Law as "accounts," i.e., single financial statements, and "consolidated accounts," i.e., consolidated financial statements) in accordance with relevant provisions of the Law. Article 431 of the Corporate Law prescribes that the accounting of a stock company shall be subject to business accounting practices generally accepted as fair and appropriate. Further, Article 432 of the Law adds the following provision on accounting records: "a stock company must prepare accurate accounting books in a timely manner as prescribed by the applicable Ordinance of the Ministry of

[8] The profession is relatively small (25,083 CPAs for a population of 126 million in Japan, January 2013) and primarily engaged in audit, taxation and management consulting. The CPA Law grants the Ministry of Finance jurisdiction over the examination, registration, deregistration and suspension of CPAs.

[9] For example, some of the standards include the Accounting Principles for Business Enterprises and Working Rules for Financial Statements, Foreign Currency Transactions, Impairment of Fixed Assets, Cash Flow Statements and Tax Effect Accounting.

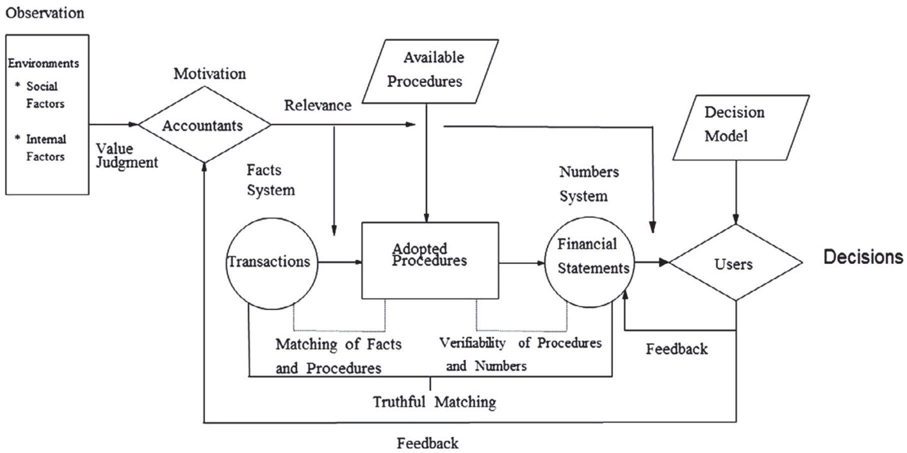

Figure 2. Accounting communication and accountants' judgments. *Source:* Takeda (1982), cited from Fig. 11.1, a framework of accounting measurement and communication.

Justice." Article 3 of the Ordinance on Company Accounting also prescribes the following: "With regard to the interpretation of terms and the application of provisions set forth in the Ordinance, generally accepted corporate accounting standards and other accounting practices shall be taken into consideration."

Fig. 2 depicts a framework of accounting communication and accountants' judgments. A change in environment for an entity would influence an accountant's motivation for choosing accounting policies. Once an accountant decides to adopt a policy on certain accounting issues that accords with the relevance of available procedures, they must continue to use reasonable and appropriate accounting methods for the issues until the next certain change occurs due to emerging environmental obstacles. The available procedures are included in the business accounting practices generally accepted as fair and appropriate, the generally accepted corporate accounting standards and other accounting practices consisting of accounting standards and guidance released by the BAC and ASBJ as indicated in the preceding section.

As the managers of listed and unlisted stock companies, directors must prepare balance sheets, income statements, business reports and supplementary schedules every financial year in accordance with the applicable ordinance of the Ministry of Justice (Article 435 of the Corporate Law). These financial statements must be audited by internal auditors in cases where the company has such auditors (Article 436 of the Corporate Law), and must also be audited by external auditors in cases where the company has such auditors (Article 436–2 of the Corporate Law). Further, they must be lodged at an annual general meeting to be held within 3 months following the balance sheet date (Article 437 of the Corporate Law), and made publicly available immediately following the meeting by newspapers and/or the company's website.

5. Dichotomy of accounting systems

Along with the progress of accounting standards converging with IFRS,[10] the necessity of accounting standards for small and medium-sized entities (SMEs), including auditing matters, has been discussed since the late 1990s. The interests related to most SME management commonly focus on how to compute taxable income to as little an amount as possible within the applicable provisions of the Japanese Corporate Income Tax Law. Because owner-managers usually lack the sufficient business accounting expertise and ability to calculate taxable income, Japanese tax accountants consult for SMEs and play an inevitable role in preparing and lodging their tax returns to the Japanese tax authorities. Further, owner-managers do not have much incentive for general purpose financial reporting due to their debt financing. In addition to these features, SMEs have no rigid internal control systems, and managers can easily override the systems.

[10] Saito (2012, pp. 192–194) briefly summarizes the backgrounds and objectives related to several accounting standards issued in the 1990s and 2000s, such as consolidated financial statements, financial instruments, impairment of long-term assets, employee retirement benefits and business combinations.

In a sense, the owner-managers of SMEs do not have much need to apply Big GAAP, as described in Table 3, which apply to general purpose financial reporting and emphasize the transparency and comparability of the accounting information to influence investors' economic decisions. Focusing on the differences among such attributes, it is necessary to institutionalize the accounting standards that correspond with SME characteristics. Hence, it would be better to promulgate accounting standards for SMEs than to apply the accounting standards to larger entities to improve the social reliability of the financial statements prepared by SMEs. Such a philosophy underpins the institutionalization of accounting for SMEs (Kawasaki, 2012, p. 10). Table 5 shows the progress of the institutionalization of accounting for SMEs in Japan.

At an early stage in the discussion, each professional body had its own political intent to expand its business opportunity, and each differed in its recognition of how to establish accounting standards for SMEs. These differences brought disorder to the discussion of accounting institutionalization (Kawasaki, 2012, p. 9). To resolve the confusion, the four interested groups (the Japanese Institute of Certified Public Accountants, the Japan Federation of Certified Public Tax Accountants' Association, the Japan Chamber of Commerce and Industry and the Accounting Standards Board of Japan) published the Accounting Guidance for SMEs in August 2005 (JICPA/JFCPTAA/JCCI/ASBJ 2005, Takeda, 2006). However, this "guidance" is not generally adopted by Japanese SMEs (Kawasaki, 2012, p. 9.).

Kawasaki (2012) points out that the Small and Medium Enterprise Agency examined this situation and reorganized the Study Group of Accounting for SMEs in February 2010, and that the Accounting Standards Board of Japan installed the Conference for the Accounting Standards for Unlisted Companies in March 2010. The former agency released a report entitled "*The Interim Report of the Study Group for Accounting for SMEs*" in September 2010, and the latter issued a report entitled "*The Report of the Conference for the Accounting Standards for Unlisted Companies*" in August 2010. Both reports conclude that new accounting rules should be established for SMEs in Japan (the Small and Medium Enterprise Agency, 2010, pp. 34–38).

In February 2011, the Small and Medium Enterprise Agency and the Financial Services Agency jointly installed the Review Committee for Accounting for SMEs and its Working Group. The Review Committee released the exposure draft entitled "*The Basic Accounting Guidelines for SMEs*" and collected public feedback (The Review Committee for Accounting for SMEs, 2011). After reviewing comments on the draft, the committee released "*The Basic Accounting Guidelines for SMEs*" in January 2012.

Fig. 3 presents the probable dichotomy of Japanese corporate accounting systems that has occurred during the current decade-long period of accounting standard development.[11] Listed firms and large entities are required to apply Japanese GAAP and may choose to apply U.S. GAAP, Pure-IFRS and Japanese-IFRS to be issued in coming years. SMEs are able to choose the Accounting Guidance for SMEs or the Basic Accounting Guidelines for SMEs. The former is mainly useful for companies with accounting advisors. Those companies are relatively larger than other companies in terms of revenue and capital size. Therefore, the companies with accounting advisors have an incentive to apply the Accounting Guidance for SMEs, which are the standards simplified from Big GAAP.

On the contrary, the Basic Accounting Guidelines for SMEs are mainly useful for comparatively smaller SMEs such as micro entities. The premise of these guidelines can be summarized into four points (Small and Medium Enterprise Agency, 2010, pp. 22–23).

(1) The "Basic Guidelines" shall provide SME managers with understandable rules to properly control their businesses (i.e., accounting useful for management).
(2) The "Basic Guidelines" shall produce accounting information that has necessary and sufficient content to inform the credit decisions made by financial institutions and the business trade (i.e., accounting that offers business opportunities with stakeholders).
(3) The "Basic Guidelines" shall sustain the accounting that is compatible with the tax accounting practices that are common among Japanese SMEs (i.e., accounting that reflects practices).

[11] The discussion in this section largely depends on a series of papers by T. Kawasaki (Professor, Konan University). The author acknowledges his helpful comments and permission to use his quotations.

Table 5
Progress of the Institutionalization of Accounting for SMEs in Japan. *Source:* Kawasaki, 2012, p. 8.

Year/month	Event
2002.3.	The Small and Medium Enterprise Agency of Japan (SMEAJ) installed the Study Group for Accounting for SMEs
2002.6.	The SMEAJ released "The Study Group Report."
2002.12.	The Japan Federation of Certified Public Tax Accountants' Associations (JFCPTA) released a report entitled "About a Setup of Accounting Standards for SMEs."
2003.6.	The Japan Institute of Certified Public Accountants (JICPA) released a report entitled "The Research Report for the State of Accounting for SMEs" (Research Report No. 8, Accounting System Committee).
2005.8.	The JICPA, JFCPTA, Japan Chamber of Commerce and Industry and Accounting Standards Board of Japan (ASBJ) released *The Accounting Guidance for SMEs* as amended. The 2012 version is currently available.
2010.2.	The SMEAJ restarted the Study Group for Accounting for SMEs.
2010.3.	The ASBJ installed the Conference for the Accounting Standards for Unlisted Companies.
2010.8.	The ASBJ released a report entitled "The Report of the Conference for the Accounting Standards for Unlisted Companies."
2010.9.	The SMEAJ released a report entitled "The Interim Report of the Study Group for Accounting for SMEs."
2011.2.	The SMEAJ and the Financial Services Agency of Japan installed the Review Committee for Accounting for SMEs and its Working Group.
2011.11.	The Review Committee for Accounting for SMEs issued an exposure draft entitled "The Basic Accounting Guidelines for SMEs," and collected public comments.
2012.1	The Review Committee for Accounting for SMEs released "*The Basic Accounting Guidelines for SMEs*."

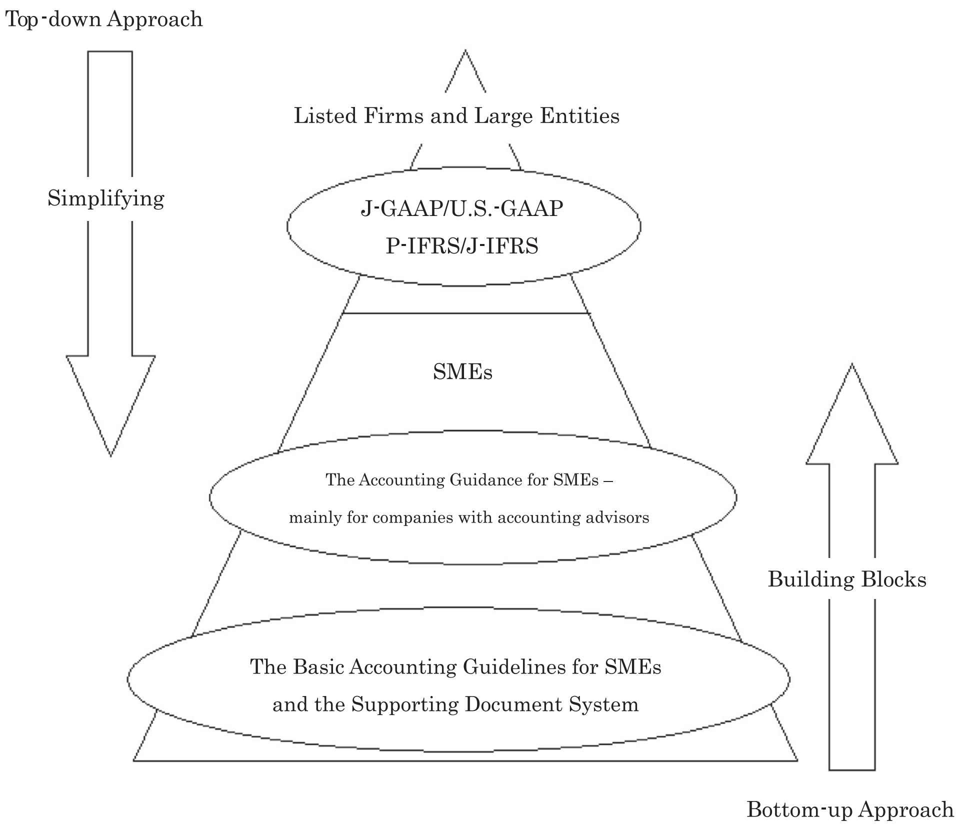

Figure 3. Dichotomy of Japanese corporate accounting systems. *Source:* Kawasaki, 2012, cf. Fig. 1, future shape of the Accounting Institution in Japan, p. 19.

(4) The “Basic Guidelines” shall lead appropriate accounting that does not require undue costs from the SMEs (i.e., accounting that is feasible for SMEs).

According to these premises, the Small and Medium Enterprise Agency presented four basic policies for creating accounting rules for SMEs (Small and Medium Enterprise Agency, 2010, pp. 35–36).

(1) The accounting rules shall reflect accounting treatments made in the SMEs’ accounting practices as conventions that include Corporate Income Tax Law and the BAC’s Accounting Principles for Business Enterprises.
(2) The accounting rules shall include accounting standards that reflect the broad differences in the SMEs’ currently accounting practices.
(3) The accounting rules shall be easy to understand and simplified for SME managers.
(4) The accounting rules shall require SMEs to keep accounting records.

Such a dichotomy of accounting systems can also be observed in China, Korea, U.K. and the U.S. in terms of the appropriateness of Big GAAP for SMEs, the cost/benefit of adopting the standards and the lack of managers’ need for the standards according to the attributes of their businesses.

The Chinese Ministry of Finance issued accounting standards for small entities in 2011 and the standards are effective for financial years starting January 1, 2013. The KASB developed the Korean Accounting Standards for Non-Public Entities based on Korean GAAP with some modifications. Korean Accounting Standards for Non-Public Entities were published in 2009. The KASB expects to converge its standards for non-public entities with IFRS for SMEs over the long term. Unlisted companies (with the exception of financial institutions and state-owned companies) can choose between full IFRS and the Korean Accounting Standards for Non-Public Entities.[12]

In the U.K., the ASB published an updated version of the Financial Reporting Standard for Smaller Entities (FRSSE) in June 2008 to reflect the changes in company law arising from the Companies Act 2006. No changes were made to the GAAP-based requirements. The updated FRSSE (effective April 2008) applies to accounting periods beginning on or after April 6, 2008, the date from which the accounting and reporting regimes for smaller companies in the Companies Act 2006 became effective. Because early adoption is not permitted, smaller companies should continue to use the FRSSE (effective January 2007) to cover their earlier accounting periods.[13]

In the U.S., the FASB issued the discussion paper entitled “*Private Company Decision-Making Framework*” in July 2012. It intended to develop a framework for evaluating the financial accounting and reporting guidance issued by the FASB and Private Company Council for private companies (FASB, 2012, cf. The purpose of this invitation to comment). The AICPA issued the exposure draft entitled “*Proposed Financial Reporting Framework for Small- and Medium-Sized Entities*” in November 2012. According to the draft (AICPA, 2012, p. 4., cf. the official version of the framework AICPA, 2013), the FRF for SMEs is a self-contained, special purpose framework intended for use by privately held SMEs in preparing their financial statements. The FRF for SMEs draws on a blend of traditional accounting and accrual income tax accounting methods. It is a less complicated and less costly accounting framework for SMEs that do not require financial statements based on U.S. GAAP.

As Fig. 3 shows, a company’s accounting practices are considered to comprise a system of knowledge formed by management judgments on business transactions. Management judgments depend on corporate cultures[14] created through personal interactions within organizations. The most influential factor within an

[12] http://www.iasplus.com/en/jurisdictions/asia/country12.

[13] http://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/FRSSE.aspx.

[14] Hofstede defines culture as “the collective programming of the mind which distinguishes the member of one human group from another” (1984, p. 21). He described the content of mental programs as values, where a value is “a broad tendency to prefer certain states of affairs over others” (1984, p. 14). Therefore, corporate culture can be considered as the collective programming of the business mind that distinguishes a member of one business entity from another. An institution is a kind of balanced and stable value system (Takeda 1982).

organization is the owner-manager's personality. In a sense, the corporate cultures of SMEs heavily depend on manager behavior. The owner-managers of SMEs ordinarily believe it unnecessary to account for external factors such as financial reporting. In the accounting sense, they tend to focus on the calculation of taxable income.

The preceding draft (AICPA, 2012, p. 4) emphasizes the following points. Special purpose frameworks must be constructed to account for the needs, sizes and types of entities in diverse economic settings. These frameworks, with the exception of the contractual basis of accounting, are commonly referred to as other comprehensive bases of accounting (OCBOA) in the United States. Special purpose frameworks include cash-, modified-cash-, tax-, regulatory- and contractual-based accounting frameworks among others, and use a definite set of logical, reasonable criteria that applies to every material item appearing in the financial statements.

There have been movements to set nationally unique accounting standards for SMEs. National accounting standards have been converged with IFRS to form single sets of high quality, understandable, enforceable and globally accepted financial reporting standards with clearly articulated principles (IFRS Foundation, 2013, para. 2); however, they are not required by SMEs in every country.[15] There are two types of SMEs: those that adopt higher levels of accounting standards drawn from local accounting standards and converged with IFRS for listed and larger companies, and those that choose smaller GAAP consisting of principles that faithfully reflect the needs of smaller or micro entities.

6. Concluding remarks

In this paper, we describe the transformation of the accounting standards in Japan over the past 2 decades and review the driving forces of this transformation according to the circumstances of financial liberalization and globalization. We also analyze the current situation of accounting standards and discover a dichotomy of accounting systems resulting from the Japanese political, economic and legal institutions. Establishing the leading criteria (Takeda, 2006) for constructing accounting systems and standards is helpful for understanding the differences between local and global corporate accounting. These leading criteria include the following five conditions.

(1) Entity of business activities: the entity is listed or unlisted.
(2) Field of business activities: the entity's field of business activities is local or global.
(3) Stakeholders in the entity: stakeholders in the entity are limited to a certain number of interested parties or diversified unlimited and potential investors.
(4) Function of the entity's financing: the entity has direct- or indirect-oriented financing.
(5) Reporting objective of the entity: the entity's reporting objective is to provide useful information that determines its value or to prepare reliable information based on accounting records.

Each of these criteria forms a corporate culture, which is a collective programming of business minds that distinguishes the member of one business entity from another. The content of mental programs is defined as values, where a value is a broad tendency to prefer certain states of business affairs over others (cf. footnote 14). As already noted in Fig. 2 (Accounting Communication and Accountants' Judgments), a company's accounting practices comprise a system of knowledge formed by management judgments made in relation

[15] Ball (2006, pp. 15–17) insists that uniform accounting standards do not always produce uniform accounting practices among countries. He gives examples of the relevant obstacles, such as the extent and nature of government involvement in the economy; the politics behind government involvement in financial reporting practices (e.g., the political influence of managers, corporations, labor unions and banks); the legal systems (e.g., common versus code law; shareholder litigation rules); the securities regulation and regulatory bodies; the depth and structure of the financial markets (e.g., the closeness of the relationship between banks and client companies); the roles of the press, financial analysts and rating agencies; the size of the corporate sector; the structure of the corporate governance (e.g., relative roles of labor, management and capital); the extent of private versus public ownership of corporations; the extent of family-controlled businesses; the extent of corporate membership in related company groups (e.g., Japanese keiretsu or Korean chaebol); the extent of financial intermediation; the role of small shareholders versus institutions and corporate insiders; the use of financial statement information such as earnings in management compensation and the status, independence, training and compensation of auditors.

to business transactions. Management judgments depend on corporate cultures that have been created through personal interactions within organizations.

One of the objectives of the IFRS Foundation (IFRS Foundation, 2013, para. 2) is to promote and facilitate the adoption of IFRS through the convergence of national accounting standards and IFRS. Behind this objective is the drive to apply IFRS to the same transactions regardless of the context and in conjunction with the social, political, economic and cultural factors of each country. The accounting standards used to evaluate a firm's value based on the principle of substance over form are difficult to apply to SMEs in Japan due to the country's corporate cultures.

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