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The Japanese Issues and Perspective on the Convergence of International Accounting Standards

*Mitsuru Misawa, Ph.D.**

I. INTRODUCTION

While the business activities of corporations are becoming more international every year, the accounting systems of individual countries seem to remain very local, differing from country to country. Recently, a cry was heard for the need for an international standardization of the accounting system so that investors can understand and properly compare the performance of corporations of other countries when they seek financing overseas. As a result of these concerns, international accounting standards are gradually taking shape.

The Norwalk Agreement was the result of a joint meeting between the U.S. Financial Accounting Standards Boards (FASB)¹ and the International Accounting Standards Board (IASB)² in September 2002. The agreement sought convergence between the International Financial Reporting Standards (IFRS)³ and U.S. standards, and laid the foundation for further

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¹ "The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." Financial Accounting Standards Board, Mission Statement, *available at* <http://www.fasb.org/> (last visited Feb. 24, 2005).

² In June 1973, the International Accounting Standards Committee was established by the joint efforts of ten countries, including the United States, Japan, England, France, and Germany. This committee was reorganized as the IASB in April 2001.

³ This is a collective name for accounting standards established by the International Accounting Standards Board (IASB) with the purpose of being approved and observed internationally. International Accounting Standards (IASs) were issued by the International

convergence of various international accounting standards.⁴ It was decided that the IFRS is to be adopted officially in 2005 as the financial reporting standard for corporations in the European Union whose stocks are traded in markets.

The European Union has asked non-E.U. entities operating in the European Union to disclose information based on the "IFRSs or an equivalent standard" starting in 2005. As of now, more than 250 Japanese corporations and Japanese local governments have issued stocks and bonds in the European Union. Most of these Japanese corporations disclosed financial information using Japanese accounting standards.⁵

Japanese efforts may be successful because Japan is negotiating diligently with the European Union and is asking for its approval of the Japanese accounting standard as an equivalent to the IFRSs. If the Japanese accounting standard fails to be recognized as an equivalent of the IFRSs, disclosure by Japanese companies based on the Japanese accounting standard currently in the European Union would not be allowed. This would severely affect the financing activities of Japanese companies seeking to raise funds in the European Union. Japanese corporations are also concerned about the possibility that Japanese accounting standards could be branded as inferior to the European or U.S. Accounting Standards, thus causing a general mistrust among investors in Japanese capital markets.⁶

There have been divergent opinions from both government and private sectors about the adoption of the IFRSs in Japan and no consensus has yet been reached. In the midst of this, on June 24, 2004, the Corporate

Accounting Standards Committee (IASC) from 1973 to 2000. The IASB replaced the IASC in 2001. Since then, the IASB has amended some IASs, has proposed to amend other IASs, has proposed to replace some IASs with new International Financial Reporting Standards (IFRSs), and has adopted or proposed certain new IFRSs on topics for which there were no previous IASs. See generally the website of the IASB at <http://www.iasb.org> (last visited Mar. 28, 2005).

⁴ In October 2002, SEC Chairman Harvey C. Pitt applauded the decisions by the FASB and the IASB to work together toward greater convergence between U.S. Generally Accepted Accounting Principles (U.S. GAAP) and international accounting standards. He said, "This is a positive step for investors in the U.S. and around the world. It means that reducing the differences in two widely used sets of accounting standards will receive consideration by both boards, as they work to improve accounting principles and address issues in financial reporting." Press Release, U.S. Securities and Exchange Commission, Actions by FASB, IASB Praised (Oct. 29, 2002), available at <http://www.sec.gov/news/press/2002-154.htm>.

⁵ Kazuo Hiramatsu and Shigeo Naruse, *Kaiki Kijun – Nichi Ou Sougo Shounin Wo Nikkei* [Accounting Standards – Hoping for Mutual Acceptance between Europe and Japan], NIKKEI, July 27, 2004, at 27.

⁶ Japanese Ministry of Economy, Trade and Industry, Report on the Internationalization of Business Accounting in Japan, available at <http://www.iasplus.com/resource/0406ifrsjapangaap.pdf>. (July 21, 2004).

Accounting Rule Council⁷ of the Japanese Government Ministry of Finance (MOF),⁸ published a memorandum entitled “Adoption of International Accounting Standards in Japan” (MOF Memorandum).⁹ The purpose of the MOF Memorandum was to canvass and compile various arguments about what should be done in Japan, from an official standpoint, regarding adopting international accounting standards to coincide with the European Union’s adoption of the IFRS in 2005.

The Japanese Corporate Accounting Rule Council (the Council) received the responsibility of setting up the business accounting system and auditing standard.¹⁰ In the MOF Memorandum, as a first step, the Council made a general observation of the international trends surrounding the IFRSs, summarized the arguments and comments about the IFRSs from a legal standpoint, and provided the Council’s comment about future tasks. The Council also provided its opinions regarding the application of the IFRSs to foreign as well as domestic corporations.¹¹

This article summarizes various arguments existing in Japan on the

⁷ The mandate of the Corporate Accounting Rule Council is defined as: “the Corporate Accounting Rule Council shall investigate and examine the processes of the establishment of business accounting and auditing standards, the standardization of cost calculation and refurbishments or improvements of corporate accounting systems as well as to report the results of such investigations and examinations to the Prime Minister, the Commissioner of Financial Services Agency, and related organizations and consult with them.” See Japanese Government Ministry of Finance, Organizational Ordinance, Article 24, No. 392 (1998), available at http://www.soumu.go.jp/s-news/2002/pdf/021017_3_06.pdf (last visited Feb. 27, 2005)[hereinafter Organizational Ordinance].

⁸ The Ministry of Finance was reorganized on January 6, 2001. The name was changed from “Okurasho” to “Zaimucho” in Japanese, but the English name still remains the same. For more information, see the Ministry’s website at <http://www.mof.go.jp> (last visited Mar. 28, 2005) [hereinafter MOF website]. The Financial Services Agency (FSA) was created on July 1, 1997, with the integration of the Banking Supervisory Agency and the Financial System Planning Bureau of the Ministry of Finance. The new FSA has integral responsibility over planning of the financial system, and supervision and inspection of financial institutions. In view of the rapid changes in the environment surrounding the economy and financial markets, the planning of the financial system focused on building a stable and vigorous financial system, and securing the efficiency and fairness in the financial markets. In the supervision and inspection of financial institutions, further efforts to maintain and improve the soundness of financial institutions were made. Coordination with foreign financial authorities was strengthened in order to cope adequately with the globalization of finance. Details on the FSA, available at <http://www.fsa.go.jp> (last visited Mar. 28, 2005) [hereinafter FSA website].

⁹ Memorandum from the Ministry of Finance on the Adoption of International Accounting Standards in Japan (June 24, 2004), available at <http://www.fsa.go.jp/news/newsj/15/singi/f-20040624-1/01.pdf> [hereinafter MOF Memorandum].

¹⁰ Organizational Ordinance, *supra* note 7, at art. 24. The council decided on Feb. 20, 2002 to take up the issue of IFRS and discuss the issue in the light of accounting and auditing standards.

current issue of standardization as well as the official position of the Japanese government expressed in the MOF Memorandum. The Japanese government's position as expressed in the MOF Memorandum is extremely important to investors in foreign countries. The author analyzes the government's positions and makes comments on the problems and issues indicated in the MOF Memorandum.

II. VARIOUS ARGUMENTS ABOUT THE IFRS IN JAPAN

A. Opinions of the Government

Japanese corporations typically generate two sets of financial statements in accordance with two laws: the Commercial Code and the Securities Exchange Law. Corporations would be freed once and for all from the burden of preparing two financial statements if the IASs were adopted. However, both the Ministry of Justice, which has jurisdiction over the Commercial Code, and the Financial Services Agency (FSA)¹², which has jurisdiction over the Securities Exchange Law, are objecting to the adoption of the IASs. The major differences between the Japanese commercial law and the IASs are shown in Appendix I, *infra*.¹³

International standards are generally more comprehensive concerning the extent of the required disclosures, but this is not always the case. For example:

1. Japan's Commercial Code does not require disclosures of a shareholder's share variation statement and cash flow statement, which are required under international standards.
2. A profit appropriation plan and supplemental statement (as to securities held, fixed assets, capital account, and reserve account) are required under the Japanese Commercial Code but are not required under international standards.
3. Under the Commercial Code, only large corporations are required to disclose consolidated statements, whereas international standards require disclosure of consolidated statements regardless of the size of the companies.
4. The Commercial Code requires disclosure of single year financial statements, but international standards require disclosure of comparative multi year financial statements.
5. Annotation is limited under the Commercial Code but it is an important part of disclosure under international standards.

¹² FSA website, *supra* note 8.

¹³ Appendix I, *infra*.

One of the reasons for opposing the imposition of international standards, the FSA states, is that "it is not accepted as a practice even in the United States to apply the International Accounting Standards to both domestic and foreign corporations as fair and appropriate accounting standards."¹⁴ However, the position of the FSA is inaccurate, since the U.S. Securities and Exchange Commission (SEC) allows the use of foreign accounting standards, including the International Accounting Standards on the condition of reconciling these figures with U.S. Generally Accepted Accounting Practice (U.S. GAAP).¹⁵ For example, Bayer AG,¹⁶ a German pharmaceutical company, filed its financial statements prepared in accordance with the International Accounting Standards (Form 20-F) with the SEC in order to be listed on the New York Stock Exchange in January 2002.¹⁷ The same rule has also been applied to Russian and Chinese corporations. Rostelecom (a Russian company) was listed on the New York Stock Exchange on February 17, 1998.¹⁸ The American Depositary Shares of PetroChina (a Chinese company) were listed on the New York Stock Exchange on April 6, 2000.¹⁹ Both filed their financial statements in accordance with Form 20-F. The New York Stock Exchange welcomes foreign corporations for trade and approves the use of the International Accounting Standards. The flexible position of the New York Stock Exchange corresponds to the change of the SEC's position on September 29, 1999 for new disclosure requirements for foreign companies that were

¹⁴ Designated Structural Reform District Promotion Office, Prime Minister's Office, Record on International Accounting Standards, *available at* <http://www.kantei.go.jp/jp/singi/kouzou/kouhyou/021022/kaitou03.pdf> (last visited Mar. 31, 2005).

¹⁵ Kimco Realty Corporation, Reconciling Non-GAAP Financial Measures, *available at* http://www.kimcorealty.com/file/Fin_SupplementalReports/2ndQuarterSupplementalPackage_7-29-2003_8-37-32AM.pdf (last visited Feb. 27, 2005).

¹⁶ Bayer Aktiengesellschaft, Report of Foreign Issuer, *available at* <http://www.sec.gov/edgar/searchedgar/companysearch.html> (last visited Apr. 4, 2005).

¹⁷ Press Release, U.S. Securities and Exchange Commission, SEC Adopts New Disclosure Requirements for Foreign Companies, (Sept. 29, 1999), *available at* <http://www.sec.gov/news/press/pressarchive/1999/99-125.txt> [hereinafter SEC Press Release]. The SEC adopted new disclosure requirements for foreign companies in 1999. The changes brought SEC disclosure requirements for foreign companies closer to the international standards endorsed in 1998 by the International Organization of Securities Commissions, the global association of securities regulators. This reduced the barriers foreign companies face when raising capital or listing their securities in more than one country. The rule changes incorporated these standards into Form 20-F, the basic disclosure form for foreign private issuers. The new requirements became effective September 30, 2000.

¹⁸ Rostelecom, SEC Reports, *available at* <http://www.rt.ru/en/icenter/reports/sec/> (last visited Feb. 26, 2005).

¹⁹ PetroChina, Annual Report, *available at* <http://www.petrochina.com.cn/english/tzzgx/ndbg.htm> (last visited Feb. 26, 2005).

allowed to use international accounting standards.²⁰

Also, the Counselor for the FSA stated his opinion in a speech he made at the General Assembly of the Corporate Accounting Rule Council on December 6, 2002 concerning his recognition of the IASB:

In a sense, I myself have a certain level of awareness that it is probably necessary to have 'restraint' against 'excessive inclination' toward IASB. I also think it is very important to grasp the situation accurately, to make sure that their discussions are based on balanced thoughts, and what kind of measures are available to guarantee such a balance. Of course I understand that IASB has no enforcing power. I think we would most likely adjust our thoughts to theirs as to what degree and in what areas based on the standpoint of cost vs. benefit. In other words, I think it is like putting the cart before the horse if the actual state of economy or industry is interpreted differently depending on which accounting principle is to be used. Therefore, I believe it is necessary to approach the issue from the standpoints of what kind of 'check' is needed on the IASB discussions or how we should lead the discussions reflecting the actual economic states of our country or how to achieve a more appropriate unbiased system.²¹

On March 3, 2003, Mark Norbom (president & CEO of GE Japan Ltd.), who sat on the 25th Japan Investment Council's meeting held under the auspices of the government of Japan to collect the wisdom of economic circles, expressed his opinion concerning the introduction of the International Accounting Standards. Norbom stated that the "introduction of the International Accounting Standards should be accelerated." The Japanese FSA responded, stating that "as to the disclosures of financial statements based on the ISA, we will judge them case by case and treat them based on the agreement at the IOSCO."²² We will also be watching closely the discussions made on the Financial Accounting Standards

²⁰ SEC Press Release, *supra* note 17.

²¹ Shizuki Saito, Statement at the Meeting of the Corporate Accounting Rule Council, available at http://www.fsa.go.jp/singi/singi_kigyuu/top.html (Dec. 6, 2002) (Mr. Saito was Chairman of Section 1 of the Council).

²² The International Organization of Securities Commissions (IOSCO) was established in 1988 under the auspices of authorities who controlled securities markets of various countries such as the Ministry of Finance of Japan and the U.S. Securities and Exchange Commission. This coincided with the expansion of corporations seeking funding in overseas markets. The IOSCO established principles concerning securities administration for authorities in charge of securities in order to achieve three objectives: (1) protect investors, (2) increase the transparency of markets for fair and efficient transactions, and (3) minimize system risks. IOSCO is a member of the International Accounting Standards Committee (IASC) and does not have its own accounting standards. Information concerning the IOSCO available at <http://www.iosco.org/> (last visited Feb. 26, 2005).

Committee of Japan [(FASCJ)].”²³

B. Opinions of Private Sectors

The Japanese Federation of Economic Organizations (known as Keidanren in Japanese)²⁴ is also taking a negative position with regard to standardization.²⁵ On July 24, 2003, the IASB Chairman Sir David Tweedie visited the Keidanren and stated that:

The purpose of IASB is to establish a uniform high quality accounting standard that can be used in all markets of the world. On account of the fact that people lost trust in accounting practices in various countries of the world through the experiences of unfortunate incidents exemplified by the Enron incident in the U.S. and the financial crises of Asian countries, it is strongly desired to establish an international uniform accounting standard. We dearly wish Japan's cooperation in this regard.²⁶

The Keidanren responded to this plea by saying:

We have yet to see the evidence that any evaluation has been made of the opinion we submitted to the IASB concerning the draft of the accounting standards and any reasons why our opinion was not adopted. Thus, we would like to see an improvement on the evaluation procedure. We believe that the IASB's thought is too biased and we wish the IASB to conduct discussion with more considerations on the realities of

²³ The FASCJ was established on July 26, 2001 by ten organizations including the Japan Federation of Economic Organizations, Japanese Institute of Public Accountants, National Securities Exchange Conference, Japan Securities Dealers Association, Japanese Bankers Association, Life Insurance Association of Japan, General Insurance Association of Japan, and Japan Chamber of Commerce and Industry for the establishment of accounting standards using the U.S. FASB as a model. It is notable that the Japanese government did not participate in it.

²⁴ The Japanese Federation of Economic Organizations is a general economic organization consisting of 1,623 companies and other organizations, which include 91 companies with foreign capital affiliations and 1,306 major representative Japanese companies. It is the strongest interest group in Japan that applies pressure on the government as well as overseas organizations by collecting opinions from business communities on many important issues for business communities ranging from economic and industrial issues to labor issues urging speedy solutions. See the Federation's website at <http://www.keidanren.or.jp/Japanese/profile/pro001.htm> (last visited Mar. 28, 2005).

²⁵ Japan Federation of Economic Organizations, Announcement, *available at* <http://www.keidanren.or.jp/japanese/policy/2004/032.html> (Apr. 20, 2004).

²⁶ Japan Federation of Economic Organizations, Economic Release No. 25, *available at* <http://www.keidanren.or.jp/japanese/journal/CLIP/2003/0722/index.html> (July 22, 2003) (translation by author).

practical business matters.²⁷

The Keidanren's comments are purposefully vague and unclear. This is a typical way in which the Japanese show hesitation in accepting another's position. The Keidanren's position is a "wait and see" position, and since the Keidanren's opinion is a collection of all companies who are members (1623 companies), this "wait and see" position is the consensus of most Japanese companies today.

C. Opinions of Journalists

The Nihon Keizai Shimbun (Japan Economic Journal) discussed this issue in an editorial article entitled "Haphazard Accounting Reforms,"²⁸ claiming that corporate accountants have lost their confidence and Japan should switch to the International Accounting Standards since "Japanese closing statements are not reliable."²⁹ A pertinent portion of the article reads:

The entire Japanese accounting system is scrutinized with eyes of doubts. One viable alternative is to switch entirely to the international accounting standards rather than waiting for the national reform of the accounting system. At this moment, twenty-eight companies have turned self-defensive by switching to the U.S. accounting standards and eight companies (one duplicated) are adopting the International Accounting Standards to distance themselves from the suspicions of the Japanese accounting system.³⁰

III. THE 2005 PROBLEM

The MOF Memorandum describes the problems expected to occur in Japan when the European Union adopts the new standards in 2005. The MOF Memorandum summarizes the expected movements in Europe as follows:

The European Union ("E.U.") decided a policy in July 2002 to make it mandatory for companies that are to make any public offerings or are traded on the markets within the E.U. to adopt the International Financial Reporting Standards ("IFRS") as the standards for preparing their consolidated financial statements as of January 2005. In

²⁷ *Id.*

²⁸ Editorial, *Haphazard Accounting Reforms*, NIKKEI, Nov. 12, 1999, at 2 (Translation by author).

²⁹ *Id.*

³⁰ *Id.*

accordance with this, the E.U. has decided to adopt the Prospectus Directive for controlling disclosures related to issues in July 2003, and the Transparency Directive for controlling continuation disclosures (periodical disclosures) later, requiring “the IFRS or accounting standards comparable to the IFRS” to be used as the standards for preparing consolidated financial statements in both directives.³¹

The Prospectus Directive issued by the European Union in April 2004 sets out the initial disclosure obligations for issuers of securities that are offered to the public or admitted to trading on a regulated market in the European Union. It is a single passport for issuers that enables them to raise capital across the European Union on the basis of a single prospectus.³² The directive only concerns initial disclosure requirements. Conditions for admissions listing remain subject to existing European and national requirements. The Transparency Directive aims to enhance transparency in E.U. capital markets by establishing rules for the disclosure of periodic financial reports and of major shareholdings for whom securities are admitted to trading on a regulated market in the European Union.³³

Last year, members of both the public and private sectors in Japan started to see warning signs in Japan that it would be difficult for Japanese corporations and securities issuers to raise funds in the European Union unless the European Union would recognize Japanese accounting standards as equivalent to the IFRSs. This eventually became known as the “2005 Problem.”³⁴

In coordination with the FSA, various organizations in Japan, including the Accounting Standards Board of Japan (ASBJ),³⁵ the Keidanren, the Japanese Institute of Public Accountants, and the Tokyo Stock Exchange contracted with the European Commission (EC) and various organizations of E.U. countries, asking them to accept the Japanese accounting standards as equivalents to the IFRS.³⁶

The FSA prepared data (in English, French and German) comparing

³¹ MOF website, *supra* note 8.

³² Commission Regulation 809/2004 of 29 April 2004 Implementing Directive 2003/71/EC of the European Parliament and of the Council as Regards Information Contained in Prospectuses, 2004 O.J. (L 149) 1 [hereinafter Prospectus Directive].

³³ Council Directive 2004/109 of 31 December 2004 on Harmonization of Transparency Requirements, 2004 O.J. (L 309) 38 [hereinafter Transparency Directive].

³⁴ For instance, Keidanren issued a paper stating that the accounting standards of Japan, the United States, and Europe have to be accepted mutually as the first step of convergence of accounting standards, and that the MOF in particular must negotiate with the authorities of member countries to accept the Japanese accounting standards. See Economic Release No. 25, *supra* note 26.

³⁵ The ASBJ was established in April 2004 as a subordinate organization of the FASCIJ.

³⁶ MOF Memorandum, *supra* note 9, at 2.

the IFRS and the U.S. and Japanese accounting standards to standards of various European organizations, especially those of the European Union. It then tried to explain, on various occasions, the differences and similarities in standards directly to the officials of the related organizations and systems, in order to convince them that Japanese standards are of the same caliber as U.S. and European accounting standards.³⁷

As a result of such efforts, it was decided that the European Union would make a further specific examination into whether the Japanese financial standards are "accounting standards that are equivalent to IFRS."³⁸ The Committee of European Securities Regulations (CESR) will make a specific examination into the financial standards and the European Union will make the final decision. The examination by the CESR is scheduled to be completed by June, 2005.³⁹

The European Union also determined that the use of "home country standards" is acceptable for companies of the countries outside the European Union until the end of 2006 for both the Prospectus Directive and the Transparency Directive.⁴⁰ With this time extension, the Japanese companies are now allowed to use Japanese standards until the end of 2006.⁴¹

IV. CURRENT DISCLOSURE REQUIREMENTS IN JAPANESE MARKETS BASED UPON DIFFERENT ACCOUNTING STANDARDS

Because of the uniqueness of Japanese accounting standards and the emergence of IFRSs, three different types of disclosures have been created in the Japanese market: (1) those based on the Japanese accounting standards; (2) those based on accounting standards of foreign countries; and (3) those based on the IFRSs. As a result, a difficult problem has surfaced: how should Japanese authorities handle disclosures? Should all three standards be accepted as legitimate? What are the conditions of acceptance?⁴²

The Securities Exchange Law of Japan originally assumed a scenario in which Japanese companies would disclose information based on the Japanese Accounting Standard. However, the Japanese market has since become internationalized and foreign companies have come to seek

³⁷ This assertion is by the Japanese government. Ministry of Economy, Trade and Industry, Report on the Internationalization of Business Accounting in Japan 13 (July 21, 2004), available at <http://www.meti.go.jp/english/report/downloadfiles/IBAreporte.pdf>.

³⁸ MOF Memorandum, *supra* note 9, at 2, 6.

³⁹ *Id.* at 6.

⁴⁰ Prospectus Directive, *supra* note 32; Transparency Directive, *supra* note 33.

⁴¹ MOF Memorandum, *supra* note 9, at 2.

⁴² *Id.* at 10-11.

financing in Japan. This presented the MOF with the problem of how to handle foreign companies that disclose their information based on their countries' or a third countries' accounting standards. The Japanese Securities Exchange Law deals with this, as explained below. As more and more Japanese companies finance overseas, some of them are now disclosing their reports in Japan based on foreign accounting standards. How the Japanese Securities Exchange Law is dealing with those cases is also described below. It is now up to the MOF to decide whether to accept the disclosures in Japan by Japanese and/or foreign companies based on the IFRSs. The Japanese law has not yet addressed these disclosure's, so one can certainly anticipate a MOF response to this issue. The MOF Memorandum reveals the official viewpoint about the IFRS for the first time, specifically whether and how disclosures made by Japanese and non-Japanese companies in accordance with the IFRS should be accepted.

This article analyzes the MOF's viewpoint on the following six potential problems presented by the convergence of Japanese and international accounting standards. These six potential cases are set out in Table 1.

Table 1: Disclosures Under Various Standards in the Japanese Market

	Foreign Company	Japanese Company
Japanese Accounting Std.	Case 1	Case 4
Foreign Accounting Std.	Case 2	Case 5
IFRS	Case 3	Case 6

A. Cases of Foreign Companies

1. Treatment by foreign companies of the Japanese standards under the existing law in Japan (Case 1)

As long as foreign companies submit financial documents prepared according to Japanese accounting standards, these documents are regarded as not compromising the protection of public interests or investors (Case 1). This disclosure is treated the same as disclosures by Japanese companies who submitted financial documents prepared according to Japanese accounting standards. The disclosure is subject to the Japanese Securities Exchange Law.⁴³

⁴³ Shoken Torihiki Ho [Securities Exchange Law], Law No. 25 of 1948, art. 127, no. 4, available at http://www.japanlaw.info/f_statements/PARENT/DX.htm (last visited Feb. 28,

2. *Treatment by foreign companies of the “home country standards” or the “third country standards” under the existing law in Japan (Case 2)*

The Rules for Financial Statements under the Japanese Securities Exchange Law⁴⁴ define the basic treatment of foreign companies concerning their financial papers:

Under the current system, it is allowed for a foreign company to submit documents concerning financial calculations that are disclosed in its ‘home country’ or in a country outside of Japan and different from its home country (‘third country’) and are prepared according to the ‘home country standards’ or ‘third country standards’ as long as the Commissioner of Financial Services Agency of Japan agrees that [the documents] are regarded as not compromising the protection of public interests or investors.⁴⁵

Based on the above rule, a judgment is made for each financial document concerning whether it can be accepted or not and, as a result, 150 filing documents and twenty foreign financial statements have been received from July 2002 to June 2003. They were prepared according to “home country standards” or “third country standards.” The accounting standards of various countries including the United States, Canada, Mexico, the United Kingdom, Germany, France, Spain, the Netherlands, Switzerland, Luxemburg, Ireland, Finland, Australia, Republic of Korea, Malaysia, Singapore, Taiwan, and Hong Kong are currently accepted and the number of accepted country standards is increasing.⁴⁶

The Securities Exchange Law stipulates that the financial documents to be submitted, regardless of their origins, must be prepared “in generally fair and appropriate manners in accordance with the terminologies, formats and methods of preparation stipulated in the Cabinet Office regulations.”⁴⁷

2005) [hereinafter Securities Exchange Law].

⁴⁴ *Id.* at art. 127. The Securities Exchange Law was enacted on April 13, 1948, and has been amended 27 times. Amendments are available at <http://www.houko.com/00/01/S23/025.HTM> (last visited Feb. 27, 2005).

⁴⁵ Securities Exchange Law, *supra* note 43, at art. 193; Regulations Concerning Terminology, Forms and Methods of Preparation of Financial Statements, MOF Ordinance No. 36, art. 127, §§ 1, 2, available at <http://www.mof.go.jp/hourei.htm> (Nov. 27, 1963) [hereinafter Ministry of Finance Ordinance]. See also Consolidated Financial Statement Rules, MOF Ordinance No. 28, available at <http://www.mof.go.jp/hourei.htm> (Oct. 30, 1976) [hereinafter Consolidated Financial Statement Rules]; Rules of Intermediate Financial Statements, MOF Ordinance No. 24, available at <http://www.mof.go.jp/hourei.htm> (Mar. 30, 1999).

⁴⁶ Discussion Memorandum from the Japanese Corporate Accounting Rule Council, at 9-10 (June 17, 2003), available at http://www.fsa.go.jp/singi/singi_kigyou/gijiroku/kikaku/f-20040617_k-giji.pdf [hereinafter Discussion Memorandum].

⁴⁷ Securities Exchange Law, *supra* note 43, at art. 193.

Acceptance of these financial documents and this treatment of foreign countries indicate that the authorities regard reports prepared under the foreign accounting standards as “generally fair and appropriate.”

Japan has not published specific rules or guidelines regarding the way in which certain documents are determined to be “not compromising the protection of public interests or investors.” The Rules for Financial Statements, however, state that this judgment is made “from the standpoint of whether the document generally has a disclosure level which is internationally acceptable.”⁴⁸ This judgment has to be made by Japanese authorities, but they have been quite flexible and liberal in accepting foreign standards in this regard.⁴⁹

The MOF Memorandum reveals an understanding that Japan’s current system has functioned well based on a principle of broadly accepting foreign financial documents, relying on the authorities making individual judgments of “[those that] are regarded as not compromising the protection of public interests or investors.”⁵⁰ Further, the MOF Memorandum describes the reason why financial documents (Case 2) based on “home country standards” or “third country standards” rather than on the Japanese accounting standards (Case 1) are allowed to be disclosed as follows:

(a) the Japanese authorities had hopes for contributing to the internationalization of the domestic market with such a move and meeting foreign companies’ specific demands about wanting to be able to conduct public offerings and to have their stocks traded in the market;

(b) evaluations of foreign companies and formations of their securities’ prices based on their financial statements already existed in their home countries and third countries. It is expected that the “judgment” function of the international market concerning such evaluations and formations of their securities’ prices is expected to work so that the authorities thought it is possible to prevent the biased existence of information for investors in the domestic market with such a move; and

(c) the authorities thought it would not cause any problem from the standpoint of “the protection of public interests or investors” in Japan so long as the financial documents of companies which are already published in the markets of their home countries or third countries where proper legal systems and accounting systems exist are to be

⁴⁸ YOSHITOSHI ASAIKE, ZAIMUSHOHYOU TOU KISOKU CHIKUJOKAI [PROVIDING A DETAILED ARTICLE-BY-ARTICLE ANALYSIS OF THE RULES ON FINANCIAL STATEMENTS] 523 (Chuo Keizai, ed., 3d ed. 1997).

⁴⁹ MOF Memorandum, *supra* note 9, at 2-6. See also Discussion Memorandum, *supra* note 46, at 10.

⁵⁰ MOF Memorandum, *supra* note 9, at 2.

published in Japanese in accordance with the Japanese disclosure formats.⁵¹

Furthermore, the MOF Memorandum implicitly assumes that the current system is based on “secondary” disclosures (i.e., financial documents that have been appropriately disclosed for a specific period of time in the home or third country before being disclosed in Japan).⁵² However, in reality, there are a few cases of “primary” disclosures (financial statements that have not been appropriately disclosed for a specific period in the home or third country that are then disclosed in Japan) of foreign companies that are subjected to the Japanese Security Exchange Law and submit their disclosure documents under the Japanese standards.⁵³ In these cases, the disclosures are examined by Japanese certified public accountants or accounting firms.

3. Arguments about foreign companies who use IFRS (Case 3)

The IFRSs does not meet the definition of either “home country standards” or “third country standards.” Therefore, the MOF is not yet sure of how to accept the financial documents prepared by foreign companies based upon IFRSs. This is especially true for foreign companies’ “primary” disclosures based upon IFRSs. The MOF Memorandum raises the following two questions concerning foreign companies: (1) should “secondary” cases, where financial documents of foreign companies are based on the IFRSs, be treated as falling under “home country standards” or “third country standards?” and (2) how should financial documents based on the IFRSs be treated when they are submitted as “primary” cases?

The MOF Memorandum proposes to maintain basically the current system for “secondary” cases. It asserts that it is unproblematic, from the standpoint of “the protection of public interests or investors” in Japan, for a foreign company to make “secondary” disclosures in Japan of financial documents based on the IFRSs as the “home country standard” or “third country standard” that have already been disclosed in that company’s home country or a third country. Although market evaluations on these documents have not been conducted in Japan, it is permissible because those companies’ securities have been valued and market studies have been conducted in their home country or in third countries. This treatment is similar to the acceptance Japan currently gives to documents that are prepared according to foreign accounting standards.

Additionally, the MOF Memorandum points out that it might be

⁵¹ *Id.*

⁵² *Id.*

⁵³ Securities Exchange Law, *supra* note 43, at art. 127, no. 4.

appropriate to conduct an “equivalency evaluation” of foreign companies’ accounting, auditing, and disclosure standards against Japanese standards as a basis for judging the quality of “the protection of public interests or investors.”⁵⁴ If such an idea is adopted, there is a possibility that some currently accepted foreign accounting standards may be rejected on the ground that they lack equivalency.

The MOF’s suggestion to conduct an “equivalency evaluation” of the IFRSs, which is used by foreign companies against those of Japan, is very appropriate since the European Union is currently examining whether the Japanese financial standards are equivalent to the IFRSs. The MOF’s attitude is considered to be reciprocal to the position of the European Union and is widely supported in Japan.⁵⁵

The MOF Memorandum then discusses cases where disclosures are made on a “primary” basis. It claims that the Japanese Government should subject all disclosures to the Japanese accounting standards in accordance with the “market-based principle,” which seeks the observance of the nation’s standards from the standpoint of the protection of public interest and investors.⁵⁶ This position is opposed to the MOF’s current official position, which says that “if it is regarded appropriate for the protection of investors in Japan as well, to disclose the financial statements that the particular company is disclosing in accordance with rules and customs of its home country for the purpose of protection of investors in said country, said financial statements can be used for said purpose.”⁵⁷ The MOF adopted the home country doctrine in 1973, when it made an announcement stating that “the standards of the accounting process to be used in preparing the financial statements shall be the standards used in the home country of said company.”⁵⁸ Therefore, the MOF Memorandum suggests a change in the MOF’s position from home country doctrine to market-based principles for disclosures on a primary basis.

The MOF’s current position in support of market-based principles for primary issues is more appropriate since primary issues have higher risks in Japanese markets. Contrary to secondary issues, which are tested for risks in their home countries or third countries, primary issues are not tested in

⁵⁴ MOF Memorandum, *supra* note 9, at 12.

⁵⁵ For example, the Security Analysts Association of Japan (SAAJ) expressed its support of the MOF’s position. See Press Release, Security Analysts Association of Japan, The SAAJ’s Opinion on the MOF’s Memorandum of the International Accounting Standards (Aug. 31, 2004), available at <http://www.saa.or.jp> [hereinafter SAAJ Press Release].

⁵⁶ MOF Memorandum, *supra* note 9, at 11.

⁵⁷ Announcement, Japanese Ministry of Finance, On Financial Documents of Foreign Companies in Accordance with the Business Performance Disclosure System of Japan (Sept. 4, 1973), available at <http://www.fsa.go.jp/news/newsj/15/singi/f-20040311-1/02-02.pdf>.

⁵⁸ *Id.*

any markets.⁵⁹

The MOF memorandum indicates, however, that a foreign company can use foreign accounting standards in Japan, including IFRS, even when documents are disclosed as “primary” disclosures. To do so, a company must meet the following conditions:

(a) As an exception, financial documents based on the IFRS or the “home country standards” can be allowed to be disclosed in Japan if the Commissioner of Financial Services Agency examines them individually and “recognizes that they do not compromise the protection of public interests or investors,” even when said financial documents have not been disclosed in the home country or a third country. In this case, however, the documents have to obey the basic rule that the documents need to be audited based on the Japanese auditing principles and the documents are written in Japanese and disclosed in accordance with the Japanese disclosure standards.

(b) As an exception, financial documents based on the “home country standards” can be allowed to be disclosed in Japan if the Commissioner of Financial Services Agency conducts the “equivalency evaluation” of the accounting, auditing, and disclosure standards of the home countries against those of Japan and “recognizes that they do not compromise the protection of public interests or investors in Japan,” even when said financial documents have not been disclosed in the home country or a third country. In following such a thought, the IFRS can be approved by conducting the “equivalency evaluation” in the accounting standards in Japan. The “equivalency evaluation” can be based on a comparison between the accounting, auditing, and disclosure standards of the home countries and those of Japan, or a comparison between international standards (e.g., the SEC standards in the U.S.) that are generally considered matching the Japanese standards.⁶⁰

These two concepts are exceptions to the market-based principle. The real difference between these two concepts, (a) and (b), is that in (b) an “equivalency evaluation” is conducted as a premise for recognizing that the standards do not compromise the protection of public interests or investors. Concept (b) is better in light of securing transparency and avoiding arbitrariness.⁶¹ The “equivalency evaluation” in terms of accounting, auditing, and disclosure standards could be a task associated with substantial difficulty. Considering it has been predicted that the European Union would take more than one year to evaluate the Japanese accounting standards, it is necessary to assume that Japan’s “equivalency evaluation”

⁵⁹ See SAAJ Press Release, *supra* note 55.

⁶⁰ MOF Memorandum, *supra* note 9, at 11-12.

⁶¹ SAAJ Press Release, *supra* note 55.

would require the same level of accuracy and time.⁶²

The MOF Memorandum states that in order to secure reliability and objectivity when judging each standard under an “equivalency evaluation,” it is necessary to examine both proper and improper applications.⁶³ This means that it is necessary to examine if the application is done properly under each standard, in addition to only a comparative examination of the standards’ text, regardless of the secondary or primary disclosure. The equivalency evaluation of the applications of standards is going to be more difficult than simply comparing the text of the standards.

B. Cases of Japanese Companies

The current system requires Japanese companies to prepare their documents in accordance with the Japanese accounting, auditing and disclosure standards from the standpoint of “the protection of public interests or investors” and does not allow Japanese companies to disclose consolidated financial statements based on accounting standards of foreign countries (Case 4).⁶⁴ As an exception (Case 5), the treatment of “U.S.-style consolidated financial statements” of Japanese companies is allowed and defined in the rules for terminology, form and preparation method of consolidated financial statements (Consolidated Financial Statement Rules or CFSR).⁶⁵

According to the CFSR, a company registered with the SEC in the United States can submit U.S.-style consolidated financial statements in accordance with the rules of the Security Exchange Law of Japan if the Commissioner of Financial Services Agency “recognizes that they do not compromise the protection of public interests or investors.”⁶⁶ This rule no longer applies if that company ceases to be registered with the SEC in the United States.⁶⁷ Japanese companies which submit U.S.-style consolidated financial statements in Japan must provide annotations describing how they were prepared and filed with the SEC, compared to the case of preparing documents based on the Consolidated Financial Statement Rules in Japan.⁶⁸

The MOF Memorandum explains that the current system was a special measure taken when Japanese companies issued American Depositary Receipts to obtain funds based on consolidated financial statements in

⁶² Shizuki Saito, Press Release, “Equivalency Evaluation” in Accounting, NIKKEI (Dec. 4, 2004), at 15.

⁶³ MOF Memorandum, *supra* note 9, at 13.

⁶⁴ *Id.*

⁶⁵ Ministry of Finance Ordinance, *supra* note 45, at arts. 87-88.

⁶⁶ *Id.*

⁶⁷ Consolidated Financial Statement Rules, *supra* note 45, at arts. 87-88.

⁶⁸ *Id.* at art. 90.

accordance with SEC standards in the United States.⁶⁹ This measure was approved on the premise that consolidated financial statements approved in the United States are based on SEC standards.⁷⁰ Due to the SEC's restrictive conditions, Japanese companies can submit U.S.-style consolidated financial statements in Japan.

The MOF Memorandum raises two questions pertaining to Case (6): (1) should Japanese companies be allowed to disclose consolidated financial statements prepared in conformance to the IFRSs?; and (2) if so, what kind of relations have to be maintained with the auditing and disclosure standards?⁷¹ The basic thought here is that in addition to accounting standards, the international convergence of auditing and disclosure standards will be necessary.⁷²

The MOF Memorandum offered the following two positions:

(a) While the current system requires the submitted financial documents to be prepared according to generally fair and appropriate standards, it does not say specifically whether the accounting standards they are conforming to have to be the Japanese accounting standards.

However, if we take the position of the "market principle," meaning that the documents submitted in Japan need to be prepared conforming to the Japanese standards from the standpoint of "the protection of public interests or investors," it may be reasonable to require Japanese companies to prepare their documents according to the Japanese accounting standards when they are disclosing their financial documents as a "primary" disclosure in Japan. (Case 4)

(b) As to the foreign accounting standards (Case 5), it may be

⁶⁹ An American Depositary Receipt (ADR) is a certificate of ownership issued by a U.S. bank, representing a claim on underlying foreign securities. ADRs may be traded in the United States in lieu of trading in the actual underlying shares in Japan. ADRs can be listed on the NYSE, AMEX, or NASDAQ. Currently thirty-one Japanese companies are issuing ADRs in U.S. markets. See Takoz, ADR, at <http://takoz.page.ne.jp/stock/adr> (last visited Feb. 27, 2005) (providing a list of these 31 companies); Investopedia, ADRs, at <http://www.investopedia.com/terms/a/adr.asp> (last visited Feb. 20, 2005) (providing further details on ADRs).

⁷⁰ Before the SEC's standards took effect in 1981, the United States allowed the use of disclosure documents that were not based on U.S. standards. Also, foreign companies are only allowed to use accounting standards different from those in the United States on the condition that they use the adjusting disclosure method. Under this method, a foreign company submitting documents according to non-U.S. accounting standards is required to explain the differences between the foreign and U.S. accounting standards to the SEC. However, no Japanese company has yet used the adjusting disclosure method. See HIROKO AWOKI, INTERNATIONAL SECURITIES TRANSACTIONS AND DISCLOSURE 202 (2000).

⁷¹ MOF Memorandum, *supra* note 9, at 14.

⁷² SAAJ is proposing further convergence. See SAAJ Press Release, *supra* note 55.

reasonable to accept them under the premise of a certain qualification such as “equivalency evaluation,” while seeking the clarification of the difference between the standards to conform to and the Japanese standards, as it is expected that it will not cause any particular problem from the standpoint of “the protection of public interests or investors” in Japan if the documents are disclosed in Japanese conforming to the formats of the Japanese disclosure standards.

While the MOF Memorandum indicated the two thoughts as shown above, it does not give any clear answer to the question of which standard is better. The MOF Memorandum also showed that the MOF believes it is appropriate to make judgments focusing more on the directions that Japanese companies take, while wanting to maintain its position of honoring Japanese accounting standards not only in Japan but also in other markets as well (including the European Union).⁷³

In other words, the MOF takes the position that it should move cautiously in making a decision on the standards, considering the fact that the European Union will be making an “equivalency evaluation” as to the Japanese standards by June of 2006. The MOF chose not to provide clear guidance at this point, thinking that it is better to wait for the European Union’s decision regarding the treatment of Japanese standards. The MOF Memorandum also states that it is necessary to consider providing annotations on the differences in the principles, procedures and display methods of the accounting processes if the disclosures of consolidated financial statements conforming to the IFRSs are to be allowed for Japanese companies (Case 6).⁷⁴

The MOF Memorandum recognizes that there have only been a limited number of financial document disclosures based on the IFRSs in the world capital market, and the rules for actual applications of the IFRSs, such as practical guides and interpretation guides, are not available for Japanese companies.⁷⁵ Consequently, in order for Japanese companies to use the IFRSs (Case 6), the Memorandum says that it would be necessary to gather the input of the concerned organizations to study how to implement them. This study would take into consideration the status of the IFRSs after its introduction in the European Union as well as the guidelines to be provided by the International Financial Reporting Interpretations Committee (IFRIC).⁷⁶ The Memorandum also points out that there is concern about

⁷³ MOF Memorandum, *supra* note 9, at 15-16.

⁷⁴ *Id.* at 16.

⁷⁵ *Id.*

⁷⁶ The IFRIC is a standards interpretation organization of the IASB. In June 1973, the International Accounting Standards Committee was established by joint efforts of 10 countries, including the United States, Japan, England, France, and Germany. This

whether Japanese companies can really prepare consolidated financial statements based on the IFRS and/or conduct auditing with the currently available, and surely insufficient, interpretations and guidelines.⁷⁷

V. DUAL ACCOUNTING REGULATIONS IN JAPAN

Dual accounting regulations have always caused problems for corporations in Japan because of the time and expense involved in duplicating work. This is one of the reasons why some Japanese companies are advocating the application of International Accounting Standards. The Securities Exchange Law in Japan was enacted as a condition imposed by the occupation authorities for the reopening of the securities exchanges.⁷⁸ The Japanese law borrowed elements of the U.S. Securities Act of 1933⁷⁹ and Securities Exchange Act of 1934,⁸⁰ and its disclosure and regulation provisions are quite similar to those found in the United States. The Japanese Commercial Code⁸¹ also contains disclosure and regulatory provisions different from those in the United States. The Japanese Commercial Code was derived in 1899 from the German Commercial Code as part of a general trend of acceptance and usage of Western law during the Meiji era.⁸² Later, during the occupation, the Commercial Code was once again reformed to be more like Anglo-American systems of company law.⁸³ There were three different types of amendments made to the Commercial Code in 1950: "(1) the rearrangement of corporate powers among shareholders, the board of directors and the corporate auditors; (2) the adoption of new ways of attracting capital into the markets; and (3) the increasing of the rights of individual shareholders."⁸⁴ Of these three, the second factor was the most important, concerning the development of the securities markets. American practice provided the concepts of authorized

committee was reorganized as the IASB in April 2001.

⁷⁷ MOF Memorandum, *supra* note 9, at 16.

⁷⁸ See Mitsuru Misawa, *Securities Regulations in Japan*, 6 VAND. J. TRANSNAT'L L. 449 (1973) (discussing the history of Japanese markets).

⁷⁹ Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (1934), as amended 15 U.S.C. §§ 77a-77m (1970).

⁸⁰ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1934), as amended 15 U.S.C. §§ 78a-78hh(1) (1970).

⁸¹ Commercial Code of Japan, Law No. 48 (Mar. 9, 1899) (amended 18 times), available at <http://www.ron.gr.jp/law/law/syohou1.htm> [hereinafter Commercial Code].

⁸² Subsequent amendments to the Commercial Code in 1899, 1911, and 1938 in the field of corporation law mainly reflected German developments. See KOTARO SHIDA, NIHON SHOHOTEN NO HENSAN TO SONO KAISEI [CODIFICATION OF JAPANESE COMMERCIAL CODE AND ITS AMENDMENTS] (1934).

⁸³ See Misawa, *supra* note 78, at 450-54.

⁸⁴ *Id.* at 450.

capital stock⁸⁵ and no-par value stock.⁸⁶ Other introductions were redeemable stock,⁸⁷ stock dividends,⁸⁸ stock split-ups⁸⁹ and transfers from reserves to stated capital.⁹⁰

The duality of accounting regulations is due in large part to historical developments. The Commercial Code regulates corporate accounting procedures⁹¹ for the primary purpose of accurately determining the amount of capital available for dividends so that the position of creditors would not be jeopardized because of an impairment of corporate properties from excessive dividend distributions. In 1950, pursuant to the Securities Exchange Law, the MOF promulgated "Regulations Concerning Terminology, Forms and Method of Preparation of Financial Statements."⁹² Subsequently, in 1963, a separate set of regulations, "Regulations Concerning Balance Sheet and Income Statements of Corporations" (Ministry of Justice Ordinance),⁹³ was issued to complement the accounting regulations specified in the Commercial Code. The Ministry of Justice Ordinance is applicable to all companies in Japan, although the Ministry of Finance Ordinance is applicable to only companies issuing or listed. These accounting regulations were probably more sophisticated than in any other country including, in some respects, the United States. Unfortunately, serious problems arose in Japan because of discrepancies between the dual accounting regulations.

The Commercial Code upheld the period profit and loss calculation method and its balance sheet template was prepared directly from accounting books by means of the derivative method.⁹⁴ Although a detailed

⁸⁵ Commercial Code, *supra* note 81, at art. 166

⁸⁶ *Id.* at arts. 166, 199.

⁸⁷ *Id.* at art. 22.

⁸⁸ *Id.* at art. 293(2).

⁸⁹ *Id.* at art. 293(4).

⁹⁰ *Id.* at art. 293(3).

⁹¹ Commercial Code, *supra* note 81, at arts. 281-295.

⁹² Securities Exchange Law, *supra* note 43.

⁹³ Japanese Government Ministry of Finance, Ministry of Justice Ordinance No. 31 (1963), available at <http://www.normanet.ne.jp/~hourei/sh031R/s380330sh031.htm> (last visited Mar. 31, 2005) [hereinafter Ministry of Justice Ordinance].

⁹⁴ Commercial Code, *supra* note 81, at art. 33 provides:

1. The following matters shall systematically and clearly be stated in the accounting books:
 1. Business properties and values thereof at the commencement of business and once in each year at a fixed time, as for a company, business properties and values thereof at the time of incorporation and at each settlement of accounts;
 2. Transactions and other matters which give influence to business properties.
2. A balance sheet shall be prepared based on accounting books at the time commencement of business and once in each year at a fixed time; and a company shall prepare it based

regulation concerning corporate accounting could be found in the Commercial Code,⁹⁵ the rule of the Commercial Code's General Regulations Concerning Commercial Books,⁹⁶ and other Ministry of Justice Ordinances were applied to items that were not specifically defined there.⁹⁷ It was requested that fair accounting practices (GAAP) be considered in interpreting the existing rules.⁹⁸

The Securities Exchange Law stipulated the terms, formats and methods to be used in the preparation of a balance sheet, a profit and loss statement, and other documents related to financial calculations. Items that were submitted in accordance with the law had to be prepared in accordance with the rules generally recognized as fair and reasonable using the terms, formats and method of preparation specified in the MOF Ordinance.⁹⁹

The initial essence of this ordinance was, from a formatting perspective, to define the method of preparing these documents and others based on an assumption that issuing companies were obligated to submit financial calculation documents. From a more practical standpoint,

thereon at the time of incorporation and at each settlement of accounts.

3. A balance sheet shall be compiled and bound together, or shall be entered in a book specially kept for that purpose.

4. A balance sheet shall contain the signature of the person who prepared it.

⁹⁵ Commercial Code, *supra* note 81 at art. 281 provides:

1. The Directors shall prepare the following documents and the annexed specifications thereof every period for settlement of accounts:

(1) A balance sheet; (2) A profit and loss account; (3) A business report; (4) Proposals relating to the reserve fund and the distribution of profits or interest.

2. The documents under the preceding paragraph need be audited by the auditors.

⁹⁶ Commercial Code, *supra* note 81, at art. 32 provides:

1. Every trader shall prepare accounting books and balance sheets for making clear the conditions of business properties and profit and loss.

2. In construing the provisions concerning preparation of the books of account, authentic accounting practices shall be taken into consideration."

⁹⁷ Ministry of Justice Ordinance No. 31, *supra* note 93.

⁹⁸ Commercial Code, *supra* note 81, at arts. 285-4 provides:

1. The monetary claims shall be valued at the nominal amount thereof; provided that, of they were purchased at the proceeds lower than the nominal amount or there is any reasonable ground, they shall be valued with reasonable decrease.

2. If there is a fear of being impossible to collect the monetary claims, the estimated amount of being impossible to collect shall be deducted in valuation.

⁹⁹ *Id.* at art. 193.

financial calculation documents provide important information related to evaluations of negotiable securities and the issuing company at the time of share placement or public offering of stocks. Therefore, the ordinance favored regulating representations in such a way that they be prepared based on a non-interruptive, uniform standard so that period and position comparisons could be easily performed. This ordinance supported making administrative investigations smoother and faster. The ordinance increased the fairness of transactions by providing more accurate representations while allowing them to be handled in a smoother fashion through a rational format that facilitated faster analyses. Here, a higher priority was placed on "consistency."

MOF ordinances (known as the Rules on Financial Statements, the Rules of Consolidated Financial Statements, and the Rules of Intermediate Financial Statements)¹⁰⁰ stipulated that the items that are not specified were supposed to follow the "corporate accounting practices" generally accepted as fair and reasonable (GAAP). For example, the Rules on Financial Statements explained, "the items that are not defined in these rules shall follow the corporate accounting practices generally accepted as fair and reasonable."¹⁰¹ In other words, the Rules on Financial Statements, a ministerial order promulgated under the Securities Exchange Law to add rules and accomplish the objective of the law encompassed the basic philosophy of promoting healthy, democratic development of the national economy. This was also the purpose of the Commercial Code. The concept of the "corporate accounting practices generally accepted as fair and reasonable" mentioned here matched the concept of the GAAP under the Commercial Code.

The Securities Exchange Law was introduced after World War II and aimed to copy the same laws established in 1933 and 1934 in the United States.¹⁰² The basic assumption of occupation authorities in suggesting the new corporate and securities legislation appears to have been that what worked well in the United States would also work in Japan. No question was raised as to the congeniality of the environment into which the new legislation was being transplanted. If Japanese procedures did not adapt well to the corporate practices of Anglo-American origin, then Japanese markets could not perform as efficiently as desired. Almost sixty years have passed since the general securities legislation was adopted and the

¹⁰⁰ Ministry of Finance Ordinance, *supra* note 45; Consolidated Financial Statement Rules, *supra* note 45; Rules of Intermediate Financial Statements, *supra* note 45.

¹⁰¹ Ministry of Finance Ordinance, *supra* note 45, at art. 1-1.

¹⁰² See Misawa, *supra* note 78 (history of how the Japanese Security Exchange Law was established). For the development of the Tokyo Stock Market, see Mitsuru Misawa, *Tokyo as an International Capital Market – Its Economics and Legal Aspects*, 8 VAND. J. TRANSNAT'L L. 1 (1974-75).

amendments to the Commercial Code were made. It is now appropriate to evaluate the efficacy and functioning of the transplanted practices. It is apparent now that this is one of the big shortfalls in the corporate accounting principles and other rules that were required for the full implementation of the laws.

VI. "LEGEND" ISSUE

Noteworthy for the adoption of International Accounting Standards in Japan is that some of the financial statements were required to include a legend as requested by the United States.¹⁰³ According to the current rule, it was necessary for financial statements of Japanese corporations written in English to have notations (legends) such as "[t]his is prepared in accordance with the Japanese Securities Exchange Law and accounting standard, and not under the accounting standards of any other countries."¹⁰⁴ This meant that the Japanese accounting process was not fully trusted internationally.¹⁰⁵ The problem did not lie with the corporations that were forced to write such statements, but rather was derivative of the antiquated accounting system of

¹⁰³ This inclusion of the legend was requested by the Big Five accounting firms in the United States. For the details on the backgrounds of the requestors, *see* Fujitsu, Legends, at <http://glovvia.fujitsu.com/jp/cybersmr/e4-1.html> (last visited Feb. 21, 2005).

¹⁰⁴ The following is an example of a legend:

Summary of Significant Accounting Policies. Basis of presentation, Nissan Motor Co., Ltd. (the "Company") and its domestic subsidiaries maintain their books of account in conformity with the financial accounting standards of Japan, and its foreign subsidiaries maintain their books of account in conformity with those of the countries of their domicile. The accompanying consolidated financial statements have been prepared in accordance with accounting principles and practices generally accepted in Japan and are compiled from the consolidated financial statements filed with the Minister of Finance as required by the Securities Exchange Law of Japan. Accordingly, the accompanying consolidated financial statements are not intended to present the consolidated financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries and jurisdictions other than Japan.

Nissan, 2003 Annual Report, *available at* http://www.infinitinews.com/corporate/corcover/NissanAR2004_en.pdf (Mar. 31, 2004). The legends of cautionary statements can only be found in the English version of financial statements based on the Japanese Securities Exchange Law, not in any financial statements of SEC registered companies prepared based on the U.S. Accounting Standards. *See, e.g.*, Nissan, 2002 Annual Report at 57, *available at* http://www.infinitinews.com/corporate/corcover/NissanAR2002_en.pdf (Mar. 31, 2003).

¹⁰⁵ Nippon Keidanren is officially against the inclusion of the legend and advocates the necessity of internationalizing Japanese accounting standards. *See* Press Release, Nippon Keidanren, The Proposition Regarding the Enterprise Accounting System (Mar. 27, 2001), at <http://www.keidanren.or.jp/japanese/policy/2001/013/honbun.html>. *See also* "What's Nippon's Keidanren?" *available at* <http://www.keidanren.or.jp/english/profile/pro001.html> (last visited Feb. 21, 2005).

Japan. The parties who were injured as a result of these unique accounting standards were the corporations who were not trusted and the investors (users of the financial statements) who were unable to obtain accurate financial information.

One can point to another problem with Japanese accounting practices. In the August 1995 annual report of the International Monetary Fund (IMF),¹⁰⁶ Japan's banking policy administration was accused of failing to take effective measures to revive the deteriorating banking system. It was further pointed out that "waiting would not recover the loss, but rather increase it," and the IMF asked Japan to take speedy action to correct these problem banks. The report also stated that: (1) market mechanisms that were supposed to help depositors and investors in selecting banks were not working because of insufficient disclosures of the operating information of the banks; and (2) it was necessary for stakeholders to demand establishment of a more clear-cut rule specifying how the necessary funds be secured for cleaning bad debts of the problematic banks, including public funds.¹⁰⁷

Another problem in this area concerns Japanese GAAP. As seen so far, the Commercial Code and the Securities Exchange Law were reliant on a comprehensive GAAP for proper implementation. The Japanese GAAP was incorporated in the Corporate Accounting Principles,¹⁰⁸ established in 1949 and based on the Commercial Code of Japan.¹⁰⁹ More specifically, the Corporate Accounting Principles were generated as an interim report by the Corporate Accounting Rule Investigative Committee of the Economic Stabilization Agency in 1949,¹¹⁰ and the "Annotations to Corporate Accounting Principles" were generated as an interim report by the Corporate Accounting Rule Council¹¹¹ of the Ministry of Finance in 1950.

¹⁰⁶ International Monetary Fund, IMF Annual Report (1996) at 29, *available at* <http://www.imf.org/external/pubs/ft/ar/96/pdf/part04.pdf> (last visited Feb. 21, 2005) [hereinafter IMF Annual Report].

¹⁰⁷ Editorial, *Nihon Keizai Shinbun* [Japanese Disclosures not Showing Real Pictures], NIKKEI, Jan. 25, 1995 (discussing a way to solve the bad debts, referring also to the IMF's report).

¹⁰⁸ These principles were established on July 9, 1949, and amended on July 14, 1954, November 5, 1961, August 30, 1972, and April 20, 1980. *See* Commercial Code, *supra* note 81.

¹⁰⁹ Commercial Code, *supra* note 81.

¹¹⁰ The Economic Stabilization Agency was established in the government as a control organ to restore the Japanese economy after World War II in 1946 and was abolished in 1952 after it had completed its functions. *See* National Institute for Research Advancement, The Economic Stabilization Agency, *available at* <http://www.nira.go.jp/pubj/seiken/v08n07.html> (last visited Feb. 21, 2005).

¹¹¹ The principle role of the Corporate Accounting Rule Council was to refurbish the financial accounting standards of Japan. This function has now been delegated to the ASBJ.

The concept of the accounting philosophy as shown in the Corporate Accounting Principles placed importance on the profit and loss calculation for a particular period, assuming that the particular period and the particular corporation was of on-going concern.

According to its preamble:

The Corporate Accounting Principles consist of the summary of practices recognized as generally fair and reasonable among those practices evolved within actual corporate accounting works and they represent the rules to be abided by corporations in processing their accountings without really having to be regulated by the laws and regulations.¹¹²

Consequently, in Japanese accounting, it is customary to honor traditional accounting practices as the practical rule to follow. This has resulted in a tendency for companies to mimic and follow whatever others are doing. This did not present any shortcomings when the economy was rosy in the years after World War II, but the same practice has caused problems in more recent years.¹¹³

The GAAP has strong enforcement power in Japan. For example, an auditor has to issue a favorable opinion as long as accounting is done in accordance with the GAAP. Therefore, it can be safely assumed, for the issue pointed out by the IMF,¹¹⁴ that the root cause of the delay in determining the amounts of bad loans lies in the basic, overly generalized philosophy contained within the Corporate Accounting Principles. If the U.S. accounting standard was applied, a loan balance, after deducting reserves, must be specified in a "net realizable value."¹¹⁵

¹¹² Commercial Code, *supra* note 81.

¹¹³ For example, Keidanren acknowledged that the Japanese accounting system needs to be changed. See Keidanren, Discussion Memo of May 25, 2000 General Meeting, *available at* <http://www.keidanren.or.jp/japanese/profile/soukai/063/01-houkoku/kaigo.html>.

¹¹⁴ IMF Annual Report, *supra* note 106.

¹¹⁵ "Net Realizable Value" is a method of determining the present value of a troubled asset to its present owner based on the assumption that the asset will be held for a period of time and sold at some future date. The present value includes future earnings that the asset is expected to generate, less the cost of owning, holding, developing and operating the asset. To compensate for these costs, the asset's projected future net cash flows are discounted using a formula that incorporates the cost of capital (the cost of paying dividends and interest). Net realizable value, therefore, is based on a formula incorporating what the asset must earn in order to pay for its share of the costs of running the business. Net realizable value is one accounting method used to calculate the present value of an asset (a loan) at some point after the loan has become past due and a book value is no longer valid. The synonym is "fair value." For the discussion of "fair value" measurements by FASB, *see* Financial Accounting Standards Board, Project Updates: Revenue Recognition, *available at* http://www.fasb.org/project/revenue_recognition.shtml (Jan. 25, 2005).

An accounting standard, from the international standpoint, resulted from thorough research and development, was generally accepted internationally, and was aimed at properly representing legal and fair accounting practices. It was not something that evolved through mere practices, but rather something that had developed theoretically and that was applied to the practices in order to provide proper information disclosure. The accounting standards used in the United States and Europe were researched and upgraded constantly by permanently established organizations to keep up with economic changes and trends. The Japanese GAAP, developed more than half a century before, was somewhat different from current international standards and was no longer deemed fit for today's economy.¹¹⁶

The problem was that even the FSA of Japan was still honoring the existing GAAP. The FSA also provided administrative services for the Corporate Accounting Rule Council, which had prepared the accounting principles. It was in a position to improve the accounting principles once problems with the principles were identified. The biggest problem resulted from the fact that the administrative offices of the Japanese government did not necessarily realize the importance of a revised accounting standard.¹¹⁷

VII. DIFFERENCES BETWEEN JAPANESE ACCOUNTING STANDARD AND IFRSS

It is important to see how the Japanese Accounting Standard is different from IFRSs. Since 1998, Japan has been aggressively working on renovating its accounting standard, i.e., the so-called "Accounting Big Bang," including reviewing the scope of consolidation, tax effect accounting, accounting for retirement benefits, financial instruments accounting, asset-impairment accounting and others, mainly to provide international alignment in consideration of the IFRSs and the U.S.

¹¹⁶ The term "accounting principles" is not a term recognized internationally. It is called "Financial Accounting Standards" in the United States and will be called "International Financial Reporting Standards" by the International Accounting Standard Board. The Japanese GAAP is essentially maintained as a kind of conceptual framework for Japanese Accounting Standards. More specific and practical rules and guidance are provided by the Japan Institute of Certified Public Accountants (JICPA) in order to keep up with economic changes. Especially after the Japanese "accounting big bang" in the recent few years, efforts to resolve the major differences in accounting standards between the Japanese GAAP and the U.S. GAAP have been made in order to fit today's economy.

¹¹⁷ Prime Minister Koizumi frequently conferred with the Minister of the FSA, Yanagisawa, in order to press forward on the fundamental clean up of the bad loan problem as his pet project of the reform he was pushing. The FSA resisted the change, claiming that they "cannot issue policies that contradict with the traditional financial administration policies and accounting principles," which clearly shows FSA's poor understanding of the bad loan problems.

Accounting Standard.

The Accounting Big Bang placed big burdens on the balance sheets of companies through market price evaluations of financial products and estimations of pension liabilities. For example, while the special losses of 400 major Japanese companies used to be at most several trillion yen, the same came to exceed ten trillion yen since 1999.¹¹⁸ On the other hand, the Accounting Big Bang contributed to promoting corporate realignment and making corporate balance sheets healthier, thus contributing to a structural renovation of the Japanese economy.

In late March 2004, when the major elements of the IFRSs were made clear, the Ministry of Economy, Trade and Industry (METI)¹¹⁹ of Japan declared that the Japanese Accounting Standard is equivalent to the IFRSs based on its comparison of the Japanese Accounting Standard against the IFRSs and the U.S. Accounting Standard, in particular, twenty-three major items including expressions of financial reports, accounting for retirement benefits, financial instruments accounting, and asset-impairment accounting.¹²⁰ It says:

With respect to the standards for recognizing impairment losses of fixed assets, Japanese accounting standards, which will be enforced in Japan from the end of March 2006, as well as U.S. accounting standards, use undiscounted cash flows as the basis whereas the IFRS uses the recoverable amount as the basis. Regarding the standards for the measurement of impairment losses, however, both Japanese accounting standards and the IFRS use the recoverable amount. Therefore, no significant difference exists between the two. With respect to the treatment when the recoverable amount bounces back, the IFRS permits reversing, whereas neither the Japanese accounting standards nor the U.S. accounting standards permit a reversal. Thus, Japanese accounting standards can thus be said to be more conservative.¹²¹

Based on such an analysis, METI concluded that, despite minor technical differences, the Japanese standard is on an equal or better level than the IFRS.¹²²

¹¹⁸ Editorial, NIKKEI, July 27, 2004, at 27.

¹¹⁹ See Ministry of Economy, Trade, and Industry, at <http://www.meti.go.jp> (last visited Mar. 29, 2005). METI is in charge of international trade and industry in the Japanese Government.

¹²⁰ Japanese METI, Report Concerning Internationalization of Japan's Business Accounting, at 14, available at <http://www.meti.go.jp/english/report/downloadfiles/IBAreporte.pdf> (last visited Mar. 29, 2005).

¹²¹ *Id.* at 12.

¹²² *Id.* at 13.

VIII. CHALLENGING TASKS FOR JAPAN

In consideration of such issues as dual accounting regulations and legends, it is advisable for Japan to change its current accounting standards to international standards. However, the MOF Memorandum lists the following five items as challenging tasks for Japan:

- (1) As to the “equivalency evaluation” of the Japanese accounting standards to be conducted in the European Union, it is important that the representatives of the government and private sectors jointly push E.U. representatives to approve the Japanese standards in the European Union as the “accounting standards comparable to the IFRSs” after 2007.
- (2) The ASBJ should actively make efforts to be involved in refurbishing and improving the Japanese accounting standards, so that its legal position can be clearly defined and the operating basis of the “FASCJ” more fully expanded.
- (3) Only a few financial documents based on the IFRSs have been disclosed at this time and there are not sufficient indices that can be used for judging them from the standpoint of “the protection of public interests or investors” in Japan. Therefore, it is important to closely watch the problems and tasks that arise from actual implementations of IFRS from this point on.
- (4) In order to allow Japanese companies to disclose their financial documents based on the IFRSs, the MOF Memorandum states that further evaluations and clarifications are needed on various issues including, but not limited to, those listed below:
 1. Relations between consolidated financial statements and individual financial statements;
 2. Retrospective corrections of consolidated financial statements of previous years when there have been changes in accounting policies; and
 3. Problems of insufficiency such as missing items and missing disclosure items such as annotations due to the differences in the preparation standards.
- (5) The so-called “legends” are said to be “epigrams” to alleviate overseas users’ risks of misunderstanding the consolidated financial statements prepared according to the Japanese accounting standards as if they were prepared according to the SEC standards or the IFRSs.¹²³

The MOF Memorandum takes the stand that certain entities, such as

¹²³ MOF Memorandum, *supra* note 9 (Translation by author).

the Japanese Institute of Public Accountants, need to actively work to improve the international notions about Japanese documents. Such attitudes persist despite the fact that the Japanese standards themselves are essentially on a level comparable to international standards. While such notions are caused by the “legends,” the wording of these legends contained within Japanese documents has improved greatly since then.

Under the situation, the countermeasures Japan can take may include a short term goal and a long term goal.

A. Short Term Goal

In the midst of the current trend of more active global corporations, international commonality is becoming mandatory and thus a global standard of corporate accounting is being developed based on the IFRSs. However, corporate accounting has been nurtured for many years in each country based on the capital market of the country. In Japan specifically, the development of corporate accounting has served a certain purpose and function in the Security Exchange Law, Commercial Law and Corporate Tax Law.

In order to avoid problems in the global activities of corporations, such as corporate financing, considering the specific situation of each country's accounting standard, each country should adopt a “mutual approval” policy, as long as the accounting standards of the respective countries are equivalent.

Whether they are “equivalent” can be evaluated by considering the opinions of market participants such as investors and corporations. More specifically, if the reference items required by investors are clearly defined in an explainable format and they are on the same level from a standpoint of usefulness and comparability, those standards should be considered equivalent.

In other words, even if there are some differences among the accounting standards, this should not present problems to investors as long as there are rational reasons for the differences and the effects of the differences are disclosed to a certain degree. Moreover, it would make more sense to simply use the standard prevailing in the country where the company's main place of business is located.

The FSA announced that it will negotiate with the European Union, with the help of Nippon Keidanren and the Japanese Institute of Certified Public Accountants, and attempt to reach an agreement to allow Japanese corporations operating in the European Union to use the Japanese Accounting Standard. The FSA wishes to counter the European Union's announcement, making the use of the International Accounting Standard mandatory to all corporations operating in the European Union, claiming that the Japanese Accounting Standard is indeed “equivalent”.

B. Long Term Goal

In the long term, the effort to converge various accounting standards to an international uniform standard is essential. The international convergence of corporate accounting is a long term goal with mutual approval as an intermediate step. It is preferable that equivalent accounting standards of various countries eventually converge into a single accounting standard of a higher quality through international cooperation. It is necessary for the IASB to take notice of the accounting standards of the important markets of the world, i.e., Japan, Europe and the United States. It should also take into account the opinions of market participants such as investors and companies and should reach a uniform integrated standard through international cooperation.

IX. CONCLUSION

Various problems exist in Japan for both domestic and international companies because the Japanese accounting system is different from international standards. Even in "sales," Japanese accounting standards are not clear and the process of defining specific terms is left to each industry's custom. In the midst of the expansion of the capital market across national boundaries, the isolation of the Japanese market from the rest of the world due to the accounting standards problem will continue to be disadvantageous to all investors and corporations of the world, as it robs worldwide investors of valuable choices and narrows the fund-raising choices for corporations.

A. Benefits and Disadvantages to Japanese Companies of Adopting International Accounting Standards

Domestically, Japanese companies are burdened with the need to prepare two kinds of financial statements due to the legal requirements to conform to both the Commercial Code and the Securities Exchange Law. The adoption of international standards will free them from this burden.

Moreover, when Japanese companies try to issue bonds and stocks, the government requires them to add a note to their financial statements such as, "This is prepared based on the Japanese accounting standards, not on international standards." This so-called "legend" problem can be eliminated once international standards are adopted.

However, since the Japanese accounting method is so unique, Japanese companies trying to receive international financing are requested to disclose information concerning their performance based on the foreign country's standards, or to disclose their methodology for adjusting differences with these standards. It will be a major handicap for those Japanese companies as they will have difficulty in efficiently raising funds in the overseas markets.

In addition, the financial statements of overseas subsidiary companies,

prepared according to the foreign countries' standards, will have to be consolidated with the financial statements of Japanese parent companies which are prepared according to the Japanese standards. This phenomenon certainly goes against the international goal of uniform accounting standards and will need to be addressed.

B. Benefits for Foreign Companies that Intend to Raise Funds in Japan

Foreign companies are allowed to submit financial statements which are prepared according to "home country standards" or "third country standards" to the MOF. However, the FSA evaluates these statements to see if the documents run the risk of compromising the protection of domestic Japanese investors. This process, of course, places heavy burdens on the foreign corporations. As a result, foreign companies may try to raise funds elsewhere in markets other than Japan. The use of international accounting standards could alleviate this problem and should be further explored with this goal in mind.

C. Benefits for Foreign Companies that Conduct Business in Japan

The financial statements that need to be submitted to the MOF by foreign companies doing business in Japan currently need to be prepared according to the Japanese accounting principles. This places a heavy burden on foreign corporations. Those companies also have to prepare financial documents according to the standards for reporting to their headquarters in foreign countries, causing a needless duplication of efforts.

In consideration of these problems, changing Japanese accounting standards to international standards would be an ideal solution. However, Japanese accounting standards were not built overnight, but rather are backed by a long history and are deeply entangled with other regulations. There are other factors, such as differences of culture and sense of values, that can prevent any conversion from proceeding efficiently. In order to adopt the International Accounting Standards, review of other related laws, such as the Commercial Law, the Securities Exchange Law and the Tax Law, would be necessary.

Consequently, a quick adoption of the International Accounting Standards is less likely to occur; chances are that change will occur slowly. It is also a problem to be considered and solved in the overall process of total internationalization of the Japanese economy.

APPENDIX I: MAJOR DIFFERENCES BETWEEN FINANCIAL DOCUMENTS/CONSOLIDATED FINANCIAL DOCUMENTS OF THE JAPANESE COMMERCIAL CODE AND INTERNATIONAL ACCOUNTING STANDARDS¹²⁴

Commercial Code	International Standards	Major differences
(1) System - Balance sheet - Earning statement - Profit appropriation plan - Supplemental statement	(1) System - Balance sheet - Earning statement - Shareholder's share variation statement - Cash flow statement - Descriptive annotation	The Commercial Code lacks basic financial tables, such as shareholder's share variation statement and cash flow statement. Also, annotation is poor. A profit appropriation plan is not required by international standards. A "supplemental statement" defined in Art. 281, Sec. 1 of the Commercial Code is not a required disclosure document and thus shareholders do not see it. The concept of a "supplementary statement" does not exist in international standards.
(2) Disclosed documents (of large corporations) - Individual statements - Consolidated statement	(2) Disclosed documents - Consolidated statement only if subsidiaries exist - Individual statement only if no subsidiary exists	Under international standards, only one financial statement is disclosed; in other words, a consolidated statement is only disclosed if subsidiaries exist.
(3) Single year statements only	(3) Comparative multiyear financial statements	International standards require disclosure of financial statements to be compared with previous year's statements. Single year statements are not required by international standards.
(4) Annotation is limited.	(4) Annotation is an important part of financial statements.	Annotations in international standards disclose rich contents.

¹²⁴ See Japanese MITI, Report Concerning Internationalization of Japan's Business Accounting, at 2-3, available at <http://www.meti.go.jp/english/report/downloadfiles/IBAreporte.pdf> (last visited Feb. 26, 2005); Akira Yokoyama, International Accounting Standards and Japanese Accounting, available at <http://www.hi-ho.ne.jp/yokoyama-a/ias&jgaap.htm> (last visited Feb. 26, 2005).

APPENDIX II: ACCOUNTING FOR IMPAIRMENT UNDER
JAPANESE, U.S., AND INTERNATIONAL STANDARDS¹²⁵

Item	Japanese Standards	U.S. Standards	International Accounting Standards
Criteria for recognition of impairment	Impairment loss is recognized when the sum of undiscounted future cash flows is less than the book value.	Impairment loss is recognized when the sum of undiscounted future cash flows is less than the book value.	Impairment loss is immediately recognized when the recoverable amount is less than the book value.
Criteria for measurement of impairment	The recoverable amount is used as the basis for the measurement of impairment loss. The difference between the book value and the recoverable amount is recognized as impairment loss.	The fair value is used as the basis for the measurement of impairment loss. The difference between the book value and the fair value is recognized as impairment loss.	The recoverable amount is used as the basis for the measurement of impairment loss. The difference between the book value and the recoverable amount is recognized as impairment loss.
Impairment loss of goodwill	<p>(1) When there is an indication of impairment, testing for impairment loss is performed on a unit that is large enough to include both a group of assets that are associated with the operation to which the good will is attributed, and good will. Any increase in the amount of impairment loss that is computed by adding good will is allocated to good will as a general rule.</p> <p>(2) When it is possible to allocate the book value of goodwill to groups of assets that are associated with the attributed operation on a reasonable basis, the book value of good will is allocated to individual asset groups first, and then the recognition of</p>	<p>Testing for the recognition of impairment loss relating to goodwill is performed in two steps, as follows:</p> <p>Step 1: The fair value and the book value of the reporting unit are compared. If the fair value of the reporting unit is less than its book value, Step 2 is performed.</p> <p>Step 2: The fair value of goodwill is computed by deducting from the fair value of the reporting unit the fair value of all recognized and unrecognized assets and liabilities. The excess of the carrying amount of goodwill over this amount is recognized as impairment loss.</p> <p>Only when a group of assets is a reporting unit or includes a reporting unit, goodwill is included in the group of assets for testing of impairment loss recognition.</p>	<p>(1) Good will is allocated to a cash-generating unit at the time it is acquired as the result of business combinations. When it cannot be allocated, a comparison is made between the book value excluding good will and the recoverable amount of the cash-generating unit being examined.</p> <p>(2) When the book value of good will can be allocated to a cash-generating unit, it is allocated to the cash-generating unit being examined. A comparison is made between the book value after goodwill allocation and the recoverable amount, either annually or whenever there is an indication.</p> <p>In connection with (1)</p>

¹²⁵ Japanese METI, Report Concerning Internationalization of Japan's Business Accounting, at 8, available at <http://www.meti.go.jp/english/report/downloadfiles/IBAreporte.pdf>, Table of Contents (last visited Mar. 29, 2005).

	<p>impairment loss is tested.</p> <p>Recognized impairment loss is allocated to good will first, and the remainder is allocated over individual component assets using a rational method, such as allocation that is proportionate with book values.</p>		<p>and (2) mentioned above, if the recoverable amount is less than the book value, impairment loss is recognized at the level of the smallest unit to which good will can be allocated. The impairment loss thus recognized is allocated to goodwill first, and the remainder is allocated over individual component assets using a rational method, such as allocation proportionate with book values.</p>
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