

A Critical Evaluation of Japanese Accounting Changes Since 1997

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Acronyms

BADC	Business Accounting Deliberation Council
BIS	Bank for International Settlements
CC	Commercial Code
CPA	certified public accountant
EPF	Employee Pension Fund
EPS	earnings per share
FSA	Financial Supervisory Agency
GAAP	Generally Accepted Accounting Standards
<i>HRE</i>	Hazama Real Estate
IAS	International Accounting Standard
IASC	International Accounting Standards Committee
ICBAS	Investigation Committee on Business Accounting Systems
IOSCO	International Organization of Securities Commissions
JICPA	Japanese Institute of Certified Public Accountants
M&A	mergers and acquisitions
MITI	Ministry of International Trade and Industry
MOF	Ministry of Finance
MOJ	Ministry of Justice
OTC	over-the-counter
R&D	research and development
ROA	return on assets
ROE	return on equity
SEC	Securities and Exchange Commission
SEL	Securities and Exchange Law
TQP	Tax-qualified Pension

Introduction

The world does not trust financial reporting by Japanese companies. A series of bankruptcies and financial scandals in the 1990s shocked both the domestic and international financial communities. The Japanese government failed for several years to reveal the extent of bad loans held by financial institutions. In response to various financial system weaknesses and international pressures, the government finally recognized the need for greater transparency in corporate financial reporting and for accounting practices closer to international standards. Between June 1997 and January 1999, the government announced details of an ‘Accounting Big Bang’ that involved sweeping reforms of financial reporting and accounting regulations. Nearly all of these changes will be implemented between fiscal years 1999¹ and 2001.

The objective of this dissertation is to examine the principal reasons and major effects of the accounting reforms announced since 1997. Chapter I looks at the historical events and foundations essential to understanding and evaluating the recent accounting changes. The next chapter discusses the Accounting Big Bang’s major causes, including a consideration of the business and regulatory environment. Chapter III critically evaluates the recent accounting changes, their effects, and remaining weaknesses. The final section provides conclusions and some reflections on where Japanese corporate financial reporting now stands.

This dissertation draws on both primary and secondary literature sources, with the use of statistics and various individual company examples to support and illustrate the arguments. Although the sections dealing with the three major accounting areas of consolidations, fair value accounting, and pensions discuss some basic accounting rules, the dissertation focuses on an analysis of the historical development, environmental framework, pressures for change, impact of revisions, and remaining weaknesses related to these three areas rather than a detailed description of accounting regulations.

The process of reporting accounting information has several participants. ‘Accounting’ as used in this dissertation refers to the preparation and publication of financial statements by corporations. Various stakeholders such as company shareholders,

¹ Almost all Japanese corporations use a fiscal year starting April 1. Fiscal year 1999 generally refers to the period between April 1, 1999 and March 31, 2000.

potential investors, banks and other creditors, tax authorities, and governmental regulatory agencies have a substantial interest in fair and complete disclosure of accounting information. For example, financial reporting disclosure requirements have developed to require companies to disclose financial results and financial position to enable investors and creditors to assess risks and returns. Company managers, who have responsibility to determine accounting policies and to prepare financial statements, and auditors, who have responsibility to check financial statements and to express an opinion on their propriety, also play key roles in the process of reporting accounting information to stakeholders. This dissertation explores the roles played by various financial reporting process participants in the Accounting Big Bang in Japan.

I. Japanese System of Accounting to 1997

This chapter provides historical background information necessary to evaluate the recent Japanese accounting changes. Part A presents the three key legal foundations of the Japanese system of financial reporting and accounting. Part B discusses the three most significant events affecting Japanese accounting since World War II. Part C highlights the accounting rules in place until the recently announced changes go into effect between fiscal years 1999 and 2001.

A. Key Foundations

Japan's so-called 'triangular legal system', not seen elsewhere in the world, prescribes financial accounting and reporting rules. The Commercial Code (CC), the Securities and Exchange Law (SEL), and the Corporate Income Tax Law each have their own accounting requirements to address their peculiar objectives, but the three laws exert influence on each other in various ways. Although Shiratori (1998, 27) comments that these three laws have created a chaotic and confusing situation, Daisai (1998, 47-8) points out that the three separate laws have substantial similarities, and each law has an equivalent requirement that generally accepted accounting principles must be used in the absence of a specific published rule.

The following sections examine the objectives, history, and principal requirements of each law making up Japan's 'triangular legal system'.

Commercial Code (CC)

The Commercial Code (CC), enacted in 1890, introduced into Japan a financial reporting system modeled after the German commercial code oriented towards creditors and tax collection. The Ministry of Justice (MOJ) administers and enforces the CC. Every joint-stock company² (*kabushiki kaisha*) must prepare non-consolidated (single-company) annual financial statements in accordance with CC rules and must submit these statements for approval at the annual general meeting of stockholders. These statements focus on determining profits available for dividend payments.

The principal objective of the CC is to protect creditors by ensuring companies calculate income available for dividends to shareholders in a conservative manner. For example, the CC requires that asset values be recorded at acquisition cost with no provision for including asset value increases in income available for dividends.

Even though the CC focuses on income available for dividends, the CC requires only the balance sheet to be published in the official gazette or in a leading daily newspaper, with a large company³ also being required to make public its income statement (Someya 1996, 47). Not even one percent of the corporations follow this limited requirement for balance sheet publication, with companies listed on a stock exchange or over-the-counter (OTC) being almost the only ones complying with this regulation. Tanaka (1998, 17-8) gives two reasons for the widespread disregard of this CC requirement. First, the MOJ does little to enforce the regulation because of the impracticability of having over one million companies publish even a summarized balance sheet. Second, except for large companies like those listed on a stock exchange, the financial statements do not get audited by certified public accountants (CPAs), so any published figures lack credibility and provide very little value to users. Since the income statement does not need to be disclosed publicly, if stockholders and creditors want to see it, they must visit a company's home office, where the corporation must make available for inspection all financial statements prepared under CC rules.

² This dissertation generally uses the term 'corporation' or 'company' when referring to a joint-stock company.

³ The CC defines a large company as one with capital over 500 million yen or with liabilities over 20 billion yen.

Securities and Exchange Law (SEL)

Although Japan has over one million *kabushiki kaisha*, the Securities and Exchange Law (SEL) applies only to about 2,600 companies with shares publicly traded on stock exchanges or over-the-counter (OTC) (Nobes 1998, 247). The MOF has responsibility to administer and enforce the SEL. The SEL requires disclosure of consolidated and non-consolidated financial statements not only at the time of issuing new securities but also through submissions of annual and semi-annual reports. A company must file its financial statements with the Ministry of Finance (MOF) within three months of the fiscal year-end and with any stock exchange on which it is listed.

The law does not require that shareholders receive financial statements, but they are available for public inspection at the MOF and the stock exchanges, or copies may be obtained from the MOF's Printing Bureau for a charge. In contrast, the US Securities and Exchange Commission (SEC) requires annual financial statements to be distributed to shareholders without charge.

Corporate Income Tax Law

Japanese corporate income tax laws and regulations have a significant effect on income measurement and financial reporting by limiting the amounts of certain types of tax deductions. Examples of these deductions include allowances for bad debts and non-performing loans, depreciation of fixed assets, and expenses for employee pensions and severance indemnities. The Corporate Income Tax Law's primary purpose is to obtain tax revenues for the government, so companies often are not allowed to record tax deductions even though a decline in the value of an asset or an increase in a liability has occurred from an economic standpoint.

The Corporate Income Tax Law generally requires expenses to be shown in a company's CC financial statements if the company wants to record expense deductions for the purpose of calculating taxable income. This requirement often leads a company to choose an accounting practice or alternative that lowers taxable income rather than one that more accurately reflects economic reality (Nobes 1998, 250). The marginal tax rate of about 50 percent for most Japanese companies provides a strong incentive to adopt accounting practices that result in the lowest possible tax payments.

If accounting standards under the CC or SEL do not address a specific accounting issue, then companies use tax guidelines to prepare financial statements. Except for a

few small differences, such as entertainment expenses not deductible for tax purposes, a company's reported income under the CC or SEL usually agrees with its taxable income (Shiratori 1998, 46).

Principal Objectives

The Japanese accounting and financial reporting system's principal objectives have been the determination of the amount of a company's profits available for dividends and the calculation of the taxable income amount. Japanese corporations have generally given precedence to the CC and corporate income tax rules rather than providing to investors and shareholders a fair representation of financial condition and operating results (*Nikkei Business* 1997b, 95). Shibata Hideki (1999, 231) considers the Corporate Income Tax Law to occupy the highest position of the three laws since a company generally put the highest priority on reducing taxes and since auditors will rarely ask a client to revise its financial statements if prepared in accordance with the tax rules.

B. Historical Development Since 1945

Although Japan introduced the CC in 1890 as the first formal corporate reporting regulation, the key events shaping Japan's system of financial reporting and accounting occurred after the end of World War II. McKinnon (1986, 72-3) identifies the three most significant events after World War II based on the coverage and importance attributed to these events in the academic literature. This section examines these three key events: the introduction of several new laws and organizations during the Allied Occupation after World War II, the revision of the CC in 1974 to require large companies to undergo independent audits, and the requirement implemented in 1977 for consolidated financial statements.

Allied Occupation

The Allied Command, during their occupation of Japan between 1945 and 1952, introduced investor-oriented financial reporting and established the framework for Japanese accounting and financial regulation, which still essentially exists today. The US, the driving force behind the Occupation Forces, sought to democratize Japan by breaking up the *zaibatsu* (huge privately-owned industrial conglomerates such as Mitsubishi and Sumitomo) and selling their shares to investors in the general public.

The Allies set up a financial reporting system modeled primarily on the US system, with the cornerstone being the Securities and Exchange Law (SEL) passed in 1947. Cooke (1994, 54) points out that 'the aim of the new regulatory system was to protect

investors in what the Occupation Forces anticipated would be a shareholder democracy'. The Securities and Exchange Commission (SEC) was established in 1948 as a regulatory body independent of the government, but soon after the Allied Forces left in 1952, the Diet abolished the SEC and transferred its responsibilities to the MOF.

Business Accounting Deliberation Council (BADC)

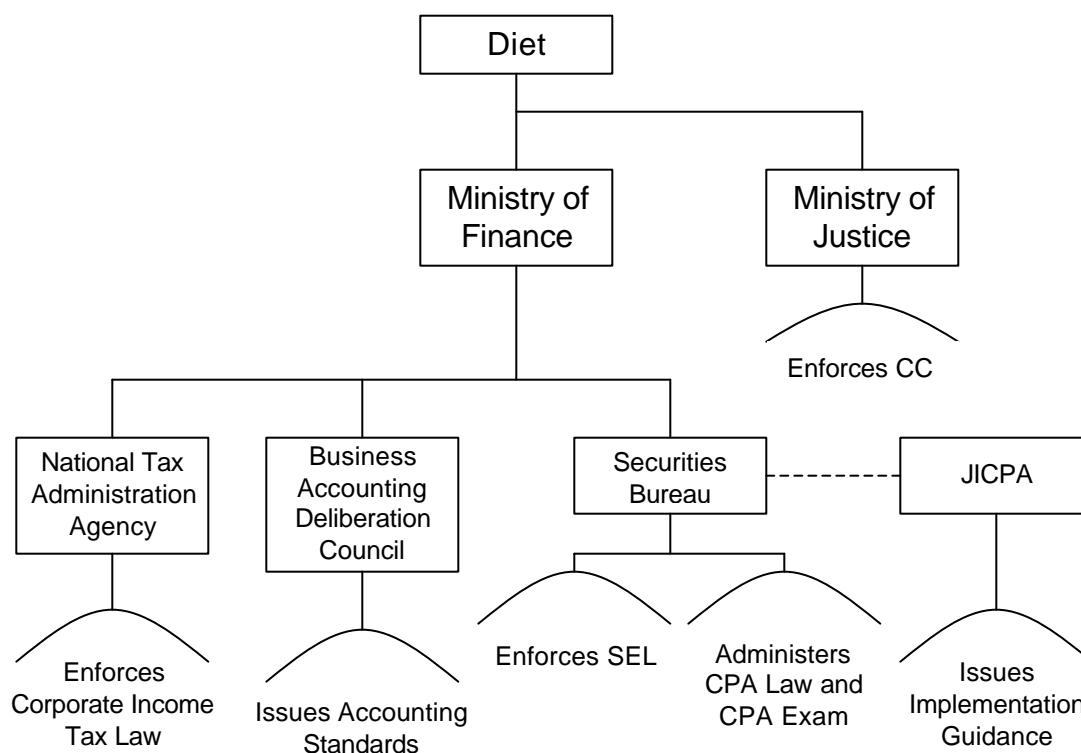
The Economic Stabilization Board of the Occupation Forces established in 1948 the Investigation Committee on Business Accounting Systems (ICBAS) as an entity independent of the government. In 1949, the ICBAS issued Business Accounting principles to provide generally accepted accounting principles (GAAP) to be followed by corporations. These principles addressed the occupying authorities' criticism of the lack of detail in financial statements and numerous differences in corporate accounting practices (McKinnon 1986, 178). These principles were to be considered in any amendments to the laws affecting financial statements (i.e., CC, SEL, tax laws), and certified public accountants (CPAs) were to follow these standards in their audits of financial statements (Cooke 1994, 58). In 1950, the ICBAS became an advisory body reporting to the MOF, and the MOF changed its name in 1952 to the Business Accounting Deliberation Council (BADC). The BADC continues to have primary responsibility to issue opinions on matters of financial accounting and reporting.

Certified Public Accountants Law

The Allied Forces established the Japanese Institute of Certified Public Accountants (JICPA) under the Certified Public Accountants (CPA) Law enacted in 1949. The JICPA exists as an organization independent of the government, but the MOF exerts strong influence over its activities since the MOF has responsibility for administering the CPA Law and the CPA examination. The CPA Law makes it compulsory for all CPAs to be members of the JICPA. Although the JICPA has no authority to issue official accounting standards, they issue implementation guidance, especially in areas where BADC accounting statements leave room for interpretation or do not exist.

MOF Dominance

As part of the regulatory changes brought about by the Allied Forces to ensure adequate disclosure to protect general investors, the MOF ended up in a predominant position to control corporate financial reporting requirements. As shown in the following chart, the MOF has responsibility for administration and enforcement of the SEL and Corporate Income Tax Law. The MOF also supervises the National Tax Administration Agency and the issuance of accounting standards by the BADC, and it effectively controls the JICPA through its administration of the CPA Law and CPA examination.



The MOF has other powers not shown in the above chart, such as direct regulatory power to license financial institutions to participate in specific market segments such as life insurance underwriting and foreign exchange trading. The MOF also provides direct unwritten administrative guidance to financial institutions under its control.

Although the Allied Forces originally established the SEC, BADC, and JICPA as independent bodies separate from the direct control of any ministry, each organization ended up under the MOF's umbrella. McKinnon (1986, 185) points out the Diet carried out these changes based on its 'preference for centralized governmental control of the regulation system rather than the devolution of control to independent authorities'.

Requirement for Independent Audits (1974)

During the 1960s, several companies manipulated profits through transactions with subsidiary companies, which resulted in losses for a large number of investors (Cooke 1994, 71). The bankruptcy of Sanyo Special Steel in 1965 especially led to sharp criticism of Japan's auditing system and the accounting practice of parent-only financial statements. The accounting manipulation by the company had been carried out by sales at inflated prices from the parent company to its subsidiaries and affiliated companies, which were not subject to an audit by a CPA firm under either the CC or SEL. The parent company used these sales to disguise losses or to inflate profits, and they went undetected until investigations following the parent company's bankruptcy.

Before 1974, the CC did not require company financial statements to be audited by a CPA firm. Although the SEL required audits of parent-only financial statements for listed companies, the subsidiaries and affiliates generally did not have audits since they were not listed on a stock exchange. The CC and SEL require that a corporation's statutory auditors examine the financial statements to ensure fraud does not take place and that directors have complied with the law and articles of incorporation. The statutory auditors, with their qualifications not clearly defined in the law, sometimes had no independence or lacked sufficient knowledge of accounting and auditing, which resulted in several cases in the 1960s of financial statement window-dressing not being detected or reported (Someya 1996, 27). Even for those companies that had audits by independent CPAs under the provisions of the SEL, the CPAs for several of the companies that went bankrupt failed to disclose to the MOF, through their audit reports, financial statement window-dressing used by the companies to manipulate profits and disguise their true financial position (McKinnon 1986, 214-5).

In order to address the problems associated with statutory auditors, the Japanese Diet enacted in 1974 a CC amendment to require companies with capital greater than 500 million yen or with liabilities greater than 20 billion⁴ yen to have their financial statements examined not only by their appointed statutory auditors but also by an accounting auditor (*kaikei kansanin*) that must be either a certified public accountant (*kônin kaikeishi*) or an auditing corporation (*kansa hôjin*) of CPAs. In order to address

⁴ This dissertation follows US usage for 'billion' and 'trillion'. Billion equals 1 followed by nine zeros, and trillion equals 1 followed by 12 zeros.

the failure of external CPAs to disclose financial statement window-dressing, the MOF implemented several measures to improve the quality of CPA audits and to strengthen financial reporting of companies subject to the SEL (McKinnon 1986, 222-6).

Requirement for Consolidated Financial Statements (1977)

The introduction of consolidated financial statements came about due to financial reporting manipulation by several firms that went bankrupt and due to the growth of multinational companies. Until 1977, consolidated financial statements did not exist in Japan, and both the CC and the SEL required financial statements to be prepared individually for each business entity. Consolidated financial statements present a group of companies as a single economic unit by showing results of operations and the financial position of a parent company and its subsidiaries as if the group were one company.

As discussed in the previous section on the implementation of the requirement for independent audits of large companies, Sanyo Special Steel and other companies in the 1960s manipulated financial statement numbers through transactions with subsidiaries and affiliates. These transactions remained unreported since the parent company did not consolidate the financial results of these subsidiaries and affiliates. The BADC issued an exposure draft on consolidated statements in 1966, one year after Sanyo Special Steel's bankruptcy, but strong opposition from large corporations and their representative organization, Keidanren (Federation of Economic Organizations), delayed final approval by the MOF for many years (McKinnon 1986, 262, 267).

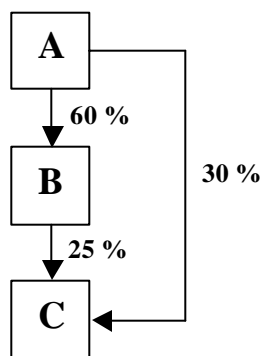
In addition to several bankruptcies by Japanese companies in the 1960s, the rapid growth of Japanese multinational companies in the 1960s and 1970s also caused the MOF to realize the inadequacy of Japan's parent-only financial statements. In the 1960s, the New York Stock Exchange barred the entry of Japanese companies since their accounts were based on the parent company only, and the first listing did not occur until 1970. Moreover, several US companies, along with the US government, lobbied the Japanese government in the early 1970s to allow US companies to be listed on the Tokyo Stock Exchange by filing consolidated financial statements. The Japanese government finally consented, and in 1973 the Tokyo Stock Exchange listed foreign company shares for the first time (Cooke 1994, 74).

C. Accounting Standards in Three Key Areas

Consolidations, fair-value accounting, and pension accounting represent the accounting areas with the most significant changes since 1997 in terms of total financial impact and number of companies affected. This section briefly summarizes basic accounting rules in effect for these three areas until the recently announced changes get implemented from fiscal years 1999 to 2001.

Consolidations

The consolidation accounting standard, implemented in 1977 for companies subject to the SEL, requires all subsidiaries for which a parent company holds more than 50 percent interest in the voting share capital must be consolidated with certain limited exceptions (e.g., subsidiary in process of liquidation). Even though a parent company does not directly hold a 50 percent interest, the accounting rules require consolidation if a parent company controls directly or indirectly more than 50 percent of the voting stock. For example, assume parent company A directly owns 30 percent of C and 60 percent of B, and B owns 25 percent of C as shown below:



Parent company A will consolidate C as a subsidiary even though it directly owns only 30 percent of voting shares. Since A owns the majority of B's shares, B's 25 percent ownership in C is combined with A's 30 percent ownership when determining whether A holds a majority interest in C's voting share capital. However, A will include only 45 percent of C's income in its consolidated income (i.e., 30 percent direct share plus 60 percent of B's 25 percent share) (Kawamura 1999a, 7 September; Yoshii 1999a, 63).

A Japanese parent company must use the equity method of accounting for any affiliated company where the parent company owns 20 to 50 percent of the voting shares. The equity method requires a parent company to recognize in its earnings its ownership share in an affiliated company. This method is frequently called 'one-line consolidation',

since a parent company records its investment in affiliates on one line on the balance sheet and its share of affiliated companies' income on one line on the income statement.

Fair-value Accounting

Japanese accounting standards specify that financial instruments such as stocks and debt securities be measured by one of two methods, acquisition cost or the lower of acquisition cost or market, with a required write-down to net realizable value in the case of permanent impairment of value. A company can choose either valuation method. The standards do not permit revaluation of financial instruments to recognize profits related to a rise in market values. Proponents of historical acquisition cost valuation point out the advantage that assets are recorded at an objective and verifiable value.

Japanese accounting regulations do not allow revaluation of fixed assets such as land. These rules are consistent with the conservative rules in the US and Germany but differ from the UK, which allows the revaluation of fixed assets, especially land and buildings (Nobes 1998, 255).

Pension Accounting

Many Japanese companies offer post-employment benefits, often referred to as pensions, with amounts based on an employee's salary, seniority, and reason for leaving. Post-employment benefits include a lump-sum payment made at the time of an employee's retirement, periodic payments made after an employee's retirement, or a combination of the two methods. Some companies allow retiring employees to choose the method of payment.

Japanese pension funds are considered to be defined benefit plans, where premiums or installments paid by companies may fluctuate over time, but the amount an employee receives in the future is determined in advance. Companies can not reduce employee pension payments in the case of installment shortfalls. The Japanese pension system includes employee pension funds (EPFs), which pay a part of what otherwise would be paid by public pension insurance, and tax-qualified pensions (TQPs) managed by companies in-house. Assets in EPFs totaled 68 trillion yen at March 31, 1997 (Miyake 1998). An EPF has a legal existence separate from the sponsoring company, but in practice most EPFs have ultimate recourse to the company in the case of funding shortfalls. In contrast to an EPF, a TQP does not have any separate assets apart from a company's general assets. A sponsoring company clearly has payment responsibility for

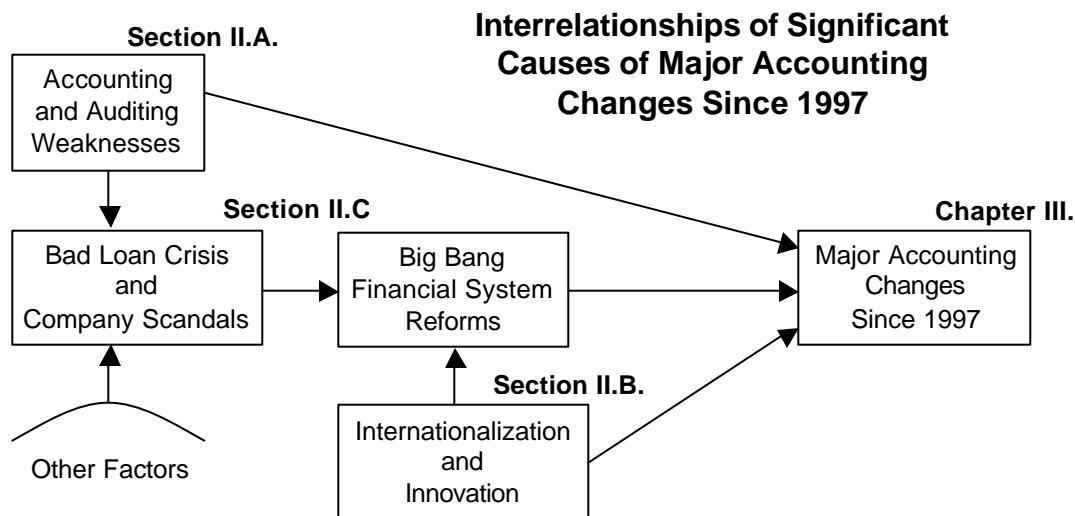
a TQP, but retired employees may not receive payments if the company goes bankrupt (Beason and James 1999, 130).

Regardless of whether employees receive a lump-sum payment or periodic payments and whether a company's pension is an EPF or a TQP, the accounting for different types of post-employment benefits generally follows the same principles. Japanese accounting rules do not require corporations to recognize a liability for vested pension obligations or for benefits related to employees' service prior to the balance sheet date.

Since 1979, the Corporate Income Tax Law has limited deductions to 40 percent of the total hypothetical pension liability as of the balance sheet date with the calculation made under the assumption that all employees voluntarily retire at that time. Although a company can establish a liability or reserve greater than the 40 percent limit, any amount over 40 percent can not be treated as a deduction in the calculation of taxable income.

II. Reasons for Accounting Changes Since 1997

The first chapter reviewed the historical background and key foundations of Japanese accounting. This chapter examines the three major influences that impelled the BADC to take action to reform Japanese accounting standards. Prime Minister Hashimoto's announcement in November 1996 to implement significant financial system reforms, referred to as the Japanese Big Bang, gave the BADC a clear mandate to pursue changes to bring the financial reporting of Japanese companies more in line with international standards. In addition, numerous accounting and auditing weaknesses induced accounting standard reforms, especially since these weaknesses contributed directly to Japan's bad loan crisis and to a string of financial-related scandals at financial institutions and other companies. Rapid financial market innovations such as derivative financial instruments and increasing internationalization of accounting standards and company financial activities also provided a strong impetus for the BADC to make changes to address the new economic realities. The following chart summarizes the three major reasons for the accounting changes since 1997, in addition to showing the interrelationships between these factors.



A. Accounting and Auditing Weaknesses

Japan's accounting and auditing weaknesses developed as a result of the country's distinctive business and regulatory environment, which the next part examines. The second part of this section identifies the major loopholes and weaknesses in the accounting rules. The final part looks at the reasons for Japan's weak auditing practices.

Business and Regulatory Environment

The unique aspects of Japan's business and regulatory environment have contributed to several accounting and auditing weaknesses, such as the lack of transparent disclosure of financial information to stockholders. This part examines three aspects of the business and regulatory environment: the *keiretsu* and main bank system, the governmental organization that sets accounting standards, and the Japanese government's approach to financial regulation.

Keiretsu and Main Bank System

The *keiretsu* and main bank business structure has contributed significantly to the shortcomings in corporate financial disclosure. The *keiretsu* business groups play a major role in the modern Japanese economy, with the six largest *keiretsu* (Mitsui, Fuji, Mitsubishi, Sumitomo, Sanwa, and Daiichi Kangyô) producing as much as 25 percent of the Japanese gross national product (Darrough, Pourjalali, and Saudagaran 1998, 315). Companies in a typical *keiretsu* group maintain close relations with one another through cross-shareholdings (*mochiai kabushiki*), interlocking directorates in which many of the same personnel sit on the boards of several *keiretsu* firms, sharing of a common main

bank, financing fellow group companies, and regular presidents' meetings for informal coordination of the group. Companies with reciprocal shareholding arrangements in a *keiretsu* have access to private accounting information not available to the general investing public and to non-members of the *keiretsu*.

The main bank provides corporate control and monitoring to *keiretsu* member companies because the bank serves as a focal point in a complicated nexus of cross-shareholdings between group member firms (Beason and James 1999, 67). Although banks are not allowed under Japanese law to own more than five percent (ten percent until 1987) of industrial companies, the proportion of listed manufacturing company stock owned by all banks in total was on average 19 percent in 1980 (Aoki 1988, 127). With several banks in total owning a substantial stake in a company, a hostile bidder has great difficulty taking control over a company.

Since banks have direct access to their customers' accounting information, they have relatively little incentive to improve external financial reporting to investors. The main bank often plays the role of first lender by reviewing and monitoring a company's investment projects, and the main bank then coordinates with other banks to supply the remainder of the requested funds. The close relationship of *keiretsu* firms and the main bank have allowed companies to take a long-term perspective rather than focusing on short-term profits since the cross-held shares effectively prevented hostile takeovers. In times of financial trouble, the main bank often serves as a lender of last resort or takes the lead in restructuring a company, including the dispatch of its own executives to take over company management (Sunamura 1994, 296-9).

Japanese companies have historically relied much more heavily on debt rather than equity as their primary financing source. In addition, institutions such as banks, insurance companies, and non-financial companies have dominated the ownership of company shares of stock. As a result, financial accounting information tended to be directed toward the needs of financial institutions and other *keiretsu*-related companies rather than individual stockholders and potential investors.

The dominance of creditors over shareholders in Japanese companies can be observed by examining the ratio of debt to total assets, which was 86 percent in 1970 and 73 percent in 1985. In comparison, US and UK firms had an average debt ratio of about 50 percent for these same years (Nobes 1998, 251). Borrowings from financial

institutions constitute over 60 percent of the debt of Japanese corporations (McKinnon 1986, 299). Through the mid 1990s, Japanese companies continued to rely heavily on borrowing rather than equity (stocks) to meet their long-term financing needs. In 1995, borrowing from financial institutions provided 52 percent of Japanese companies' financing needs, whereas equity financing made up 40 percent and company-issued bonds 8 percent. In contrast, US firms used stocks for 76 percent of their financing requirements, bonds for 14 percent, and borrowing from financial institutions for only 10 percent (Katayama 1997).

Institutional shareholders dominate the ownership of Japanese companies, so few incentives have existed to address the financial information needs of individual shareholders. In 1950, as a direct result of the *zaibatsu* dissolution mandated by the Allied Command, individual share ownership rose to 69 percent of the total market value of listed companies, but this figure steadily declined to less than 25 percent in 1985 and has remained at about the same level through 1995 (Aoki 1988, 117, 124; Tokumasu and Katô 1997, 123). This level is quite low for industrialized countries, with US individual investors, for example, holding about half of total outstanding shares (Darrough, Pourjalali, and Saudagaran 1998, 315).

The decrease in individual share ownership in Japan occurred as several *keiretsu* formed and rapidly grew in the 1950s and 1960s (Aoki 1988, 125; McKinnon 1986, 295). The former *zaibatsu* groups initially set up cross-shareholding arrangements to circumvent the rules established by the Allied Command against holding companies. Between 1985 and 1995, financial institutions and non-financial corporations owned over 40 percent and about 25 percent respectively of the total value of stock of listed companies⁵ (Tokumasu and Katô 1997, 123).

Cross-shareholding has weakened the effectiveness of corporate governance in Japan. With banks and affiliated companies holding the majority of shares in most large Japanese companies, the system of accountability to stockholders that operates in the US and other industrialized countries has not developed much in Japan. Japanese companies can readily obtain shareholder approval of management proposals at annual shareholder meetings. Boards of directors usually consist almost entirely of company executives or

⁵ In addition to Japanese individual and institutional investors, foreign investors held less than 10 percent of the stock of listed companies.

executives of financial institutions and other companies with cross-shareholdings. This lack of external independent directors deprives small shareholders of someone to look after their interests.

Since 1993, when the Commercial Code was amended to strengthen shareholder rights, numerous shareholder class action lawsuits have been filed against company directors and executives for bankruptcies or for scandals that caused shareholders to suffer significant losses due to declines in share prices. For example, compensatory damage claims of US\$1.1 billion have been filed against 38 Daiwa Bank directors and statutory auditors for illegal transactions at the bank's New York branch. Even though shareholders have not yet won a lawsuit in the case of a bankruptcy or scandal, company directors have become more aware of the need to prevent scandals and bankruptcy by having effective internal control systems and internal audits (Yokoyama 1999f).

Accounting Standard Setting Group

In contrast to independent non-governmental groups that establish accounting standards in other industrialized countries such as the US, Great Britain, and Germany, the Japanese government effectively controls all aspects of financial accounting and reporting. The Ministry of Finance controls the Business Accounting Deliberation Council (BADC), which establishes financial accounting standards for businesses. The MOF also has responsibility for the administration and enforcement of the SEL and related accounting regulations. Although the BADC has members from industry, universities, and the accountancy profession in addition to the government, the MOF must approve the appointment of members to the Council (Cooke 1994, 58). The MOF's control over the BADC can lead to decisions made for the purpose of politics rather than improved financial reporting. For example, the MOF made a temporary change only in 1998 and 1999 to let financial institutions revalue their land holdings in order to improve their capital ratios, even though this revaluation was inconsistent with the historical cost method that had been required for several decades.

Governmental Regulators

The Japanese approach to financial regulation builds on favors, deals, and reciprocal obligations. The Japanese government, specifically the MOF, has long provided administrative guidance and supervision to banks and other financial institutions, oftentimes behind closed doors according to unwritten rules. Until the bankruptcies of several financial institutions in 1997, the MOF had emphasized the prevention of bankruptcies and implicitly guaranteed the viability of banks, life insurance companies, and other financial institutions. Regulators used an ‘escorted convoy’ (*gosô sendan*) approach, which kept financial institutions moving along in the same direction at the same pace, making sure none of them sank including virtually bankrupt institutions.

The practice of *amakudari* weakens the credibility of official supervisory policy and undermines its effectiveness. *Amakudari*, which literally means ‘descent from heaven’ in Japanese, refers to the practice of high-ranking retiring MOF officials taking high-paying positions in private companies regulated by the MOF. In the early 1990s, the presidents of one-quarter of Japan’s 150 largest private-sector banks had obtained their positions through the *amakudari* system. The MOF directly controls 92 quasi-governmental special corporations, such as the Japan Development Bank, Export-Import Bank, and Housing Loan Corporation, which employed over 500 thousand people in 1994 and held capital totaling about 25 trillion yen. Retired MOF officials held 58 percent of the directorships of these special corporations. Several top MOF officials have ‘retired’ multiple times, moving from the MOF to a position at one of these special corporations and then to a private-sector firm, each time receiving a substantial lump-sum retirement payout (Hartcher 1998, 34-6, 43, 120). The *amakudari* system has the potential for favor trading between regulators and regulated institutions, such as the MOF expressing willingness to overlook a firm’s violation of laws in exchange for lucrative positions for retiring or retired MOF officials.

The MOF’s extremely close relationship with the financial institutions that it regulated sometimes led to corruption. In early 1998, several MOF officials from the bank inspection division were accused of extortion, taking bribes, and influence peddling related to providing banks with advance warning of impending inspections from 1994 to 1996. Ten large banks and five large securities firms engaged in giving bribes to bank inspectors (Hall 1998, 46-7; Kin’yû Kantoku Chô 1998a).

Loopholes and Weaknesses in Accounting Rules

Japanese accounting rules have many loopholes that have allowed companies to manage earnings to their advantage. Companies frequently have used hidden gains and losses, non-consolidated subsidiaries and affiliates, and undisclosed pension liabilities to manipulate their reported profits and to understate their actual and contingent liabilities. This part examines a company's motivation for managing earnings and analyzes the major weaknesses in Japan's accounting standards, with specific company examples used to demonstrate the significance of these weaknesses.

Management of Earnings

From a company's standpoint, the best financial statements are those that bring about the highest possible stock price and minimum cost of capital, not ones that display the company's financial condition and results most fully and fairly. Most companies try to downplay contingent liabilities, maximize growth expectations, and minimize actual and perceived risk in order to achieve these objectives. Companies can boost reported net income through such methods as shifting current expenses to a later time period, selling assets whose market value exceeds book value, and failing to record or disclose liabilities such as debt guarantees.

Tanaka (1998, 20-3) explains that Japanese companies consider accounting rules to be maximum standards and almost never voluntarily disclose information not required by law. In contrast, American and British companies generally consider accounting regulations to be minimum standards and will disclose information beyond the requirements as a means to meet market demands for disclosure, attract investors, and provide company public relations. For example, American financial institutions quickly announced losses related to the 1997 Asian currency crisis, whereas many Japanese financial institutions did not disclose their losses specifically related to the crisis.

Hidden Profits and Losses

In the period up to the bursting of the bubble economy in about 1990, most Japanese companies built up a huge amount of hidden profits as overall inflation and rising stock and real estate prices continued for many years. Hidden profits arise when the market value of a company asset exceeds its book value, usually original acquisition cost, reported on a company's balance sheet. Up to 1990, even if companies encountered a financial downturn, they easily could use hidden profits whenever necessary to cover

losses by selling off assets with book values less than market values (Endô 1999, 68). Even after the downturn in stock prices during the 1990s, some Japanese companies continue to hold huge amounts of hidden profits that can be used as a 'safety value' in whichever accounting period they need to lift up sagging earnings or prevent showing a loss. For example, Toyota Automatic Loom Works, Ito-Yokado, Fuji Electric, and Keisei Electric Railway all have hidden profits in marketable securities more than double the amount of their stockholders' equity. Ito-Yokado holds 1.6 trillion yen in hidden profits, more than any other Japanese non-financial company (*Nikkei Business* 1997a, 91).

When the asset price 'bubble' burst, real estate and stock prices fell dramatically between 1989 and 1993. Equity prices, as measured by the Nikkei Stock Index, fell sharply from an all-time high of nearly 40,000 in December 1989 to 21,000 in September 1990 to just under 15,000 in 1992. Land prices fell 40 percent on average between 1989 and 1993 (Beason and James 1999, 82; Someya 1996, 142).

When the stock market turned downward, the hidden stock profits of Japan's 21 major banks dropped from 46 trillion yen in 1990 to 17 trillion yen in 1992, and life insurance companies' hidden profits slid from 45 trillion yen in 1988 to 17 trillion yen in 1992. Although financial institutions in the aggregate still held hidden profits in 1992, some weaker banks and life insurance companies reached the point of holding hidden losses (Hartcher 1998, 103-4). By August 1998, the total estimated amount of hidden stock losses for the 19 largest banks had reached 2.6 trillion yen (Hiramatsu 1998, 29).

Japanese accounting regulations allow a choice of two methods, cost basis or lower of cost or market, to value marketable securities such as stocks. Someya (1996, 144) questions the desirability of allowing corporations to select different accounting techniques that lead to significantly different reported profit figures. When the Nikkei Index fell almost 50 percent from December 1989 to September 1990, nine of the twelve largest banks used the cost basis method to value their marketable securities, which allowed them to avoid recording an estimated one trillion yen in losses. In contrast, three of the banks had to report market valuation losses since they used the lower-of-cost-or-market method. Accounting rules require companies that use the cost method to write down the value of financial instruments in the case of permanent impairment, but company management can easily get around this requirement by convincing its auditors

that the decline in value is considered temporary, not permanent, in order to avoid reporting a loss.

In the mid 1990s, Japanese financial institutions needed profits to offset the write-off of problem loans, so they converted hidden profits to realized profits by selling large amounts of their stock portfolio. For example, for the fiscal year ending March 31, 1994, the 21 major Japanese banks used 2.4 trillion yen in profits from stock sales to cover 63 percent of their total write-offs of problem loans. In the following year, stock sale profits of 4.1 trillion yen offset about three-quarters of the non-performing loan write-offs. Even though the banks sold a huge amount of stocks to realize profits, most of the banks bought back stocks in the same companies at a higher price in order to preserve their long-term relationship and to respond to MOF pressure that banks not be net sellers of stocks in order to prop up stock prices. After the selling and buying back of stocks, banks still owned 26 percent of the total market value of stocks in 1995, the same percentage as banks owned in 1990 (Hartcher 1998, 153-4).

Japanese non-financial companies also have significant hidden losses or gains related to marketable securities. Listed non-financial companies' parent-only financial statements had a total of 34 trillion yen in hidden profits at March 31, 1997, down slightly from 51 trillion yen at March 31, 1996. Even with this decline in stock prices, total hidden profits exceeded annual ordinary income by 2.6 times (Tokumasu and Katô 1997, 160-1). Although many non-financial companies have hidden profits, some large companies have a significant amount of hidden losses. For example, the following three large non-financial companies (i.e., capital greater than 5 billion yen) had hidden losses in marketable securities that exceed their stockholders' equity as of March 31, 1997: Ikeda Bussan, Ôkura Shôji, and Janome Sewing Machine with 82, 15, and 3 billion yen of hidden losses respectively (*Nikkei Business* 1997a, 91). This means they would fall to a negative capital position (i.e., liabilities exceed assets) if their marketable securities had to be recorded at market prices rather than cost. According to Japanese law, a company in a negative capital position can not pay dividends for five years and will suffer the revocation of the listing of their company's stock on a securities exchange if the situation continues for three years.

Among the 30 Japanese companies listed on the New York Stock Exchange and who submitted financial statements in 1995 according to US accounting standards,

which require fair-value accounting for marketable securities, several companies' return on equity (ROE) differed significantly with and without the application of fair-value accounting. For example, Mitsubishi Shôji's ROE dropped from 6.0 percent to 3.9 percent when the company applied fair-value accounting to their marketable securities, and Kubota's ROE declined from 8.5 percent to 5.7 percent (*Nikkei Business* 1997b, 96-7). This decline in ROE primarily results from a higher equity total when the company revalues marketable securities to higher levels.

Since Japanese accounting rules do not require revaluation of real estate values, many Japanese companies, especially those who acquired land before World War II, have significant hidden reserves because real estate has increased significantly in value since the acquisition date when they recorded the assets at cost. Although real estate values fell from the peak in 1989, substantial reserves still exist. For example, the 19 largest Japanese banks own land as of April 1998 with a total book value of 1.1 trillion yen and an estimated total market value of 5.5 trillion yen (Hiramatsu 1998, 30). On the other hand, some companies, especially those who bought land during the speculative bubble economy of the late 1980s, have land with book values far in excess of current market values.

Non-consolidated Companies

Japanese accounting rules only considered a company's ownership percentage in another entity when determining whether to apply consolidation accounting (more than 50 percent) or the equity method of accounting for affiliates (20 to 50 percent), rather than taking into consideration other factors that indicated a company effectively controlled the other entity. These strict ownership criteria led to abuses by companies wanting to hide liabilities, poor financial results, or overvalued assets.

One example illustrates how such abuse occurs (*Nikkei Business* 1997a, 93-4). A parent company Hazama owns 13.4 percent of Hazama Real Estate (HRE). In addition, Hazama's wholly-owned subsidiary, Hazama Industrial, owns 6.2 percent of HRE, so Hazama's total investment percentage, direct and indirect, comes to 19.6 percent, just short of the 20 percent required for consolidation through use of the equity method. However, Hazama's ownership percentage does not accurately reflect its extent of control over HRE's operations. Hazama provided financing of 41 billion yen of long-term loans in addition to providing 89 billion yen in debt guarantees for HRE's loans. Since HRE's liabilities total 153 billion yen, Hazama has ultimate responsibility for 85 percent of

them. Personnel relationships are also quite close, with five people serving as directors in both companies. Moreover, in fiscal year 1996, Hazama recorded 5.5 billion yen as an extraordinary loss for write-offs of receivables from HRE.

Even though Hazama appears to have significant influence over HRE's operations, the consolidation accounting rules do not require Hazama to recognize its share of HRE's net income and to disclose the 89 billion yen in debt guarantees of HRE's loans. HRE recorded a 1 billion yen loss for fiscal year 1996 and a 500 million yen loss in the previous year, but the accounting rules do not require Hazama to recognize any of these losses in its income statement. HRE's accumulated losses have grown to a negative capital position of 5.2 billion yen, but Hazama disclosed none of this.

As part of the consolidation accounting standard implemented in 1977, the MOF permitted exemption from consolidation if total assets or sales of non-consolidated subsidiaries were less than 10 percent of those of the parent company and other consolidated subsidiaries. This rule allowed companies to organize subsidiaries in such a way as to avoid consolidation. Even though the MOF extended the 10-percent materiality rule to income in 1983, corporations continued to have significant opportunities to exclude many subsidiaries from consolidation.

Since 1983, parent companies have also been able to apply a separate 10-percent materiality exclusion calculation to their percentage share of the net income of affiliated companies to which the equity method of accounting would otherwise have to be applied. In other words, the parent company did not need to apply the equity method of accounting to affiliates if the following ratio did not exceed 10 percent:

$$\frac{\text{Parent company's share in net income of affiliated companies to which equity method is not applied}}{\text{Parent company's total net income (including share in net income of affiliated companies to which equity method is applied)}}$$

These two materiality exclusion rules have allowed Japanese companies to not consolidate many subsidiaries and to not include in earnings their share of affiliated companies' net income or loss (McKinnon 1986, 275-6, 281, 285-7). For example, Fujikura's 1990 financial statements disclosed that the company consolidated only 14 of 53 subsidiaries and applied the equity method of accounting to only five of 23 affiliates

(Beckman 1998, 18). Effective in 1995, the MOF reduced the materiality exclusion rule percentage from 10 percent to 3-5 percent, but even this reduced percentage allows companies to exclude many subsidiaries (Shiratori 1998, 181).

Financial analysts for securities firms and other financial institutions often try to analyze the differences between consolidated and parent-only earnings to better understand a Japanese company's financial position and results (Beckman 1998, 18). The weaknesses in Japan's consolidation accounting rules and practices lead to this type of financial statement analysis. Parent-only and consolidated earnings or other financial measures can vary greatly, as shown by the following examples. Mitsui Shipbuilding's parent-only pre-tax operating income for fiscal year 1996 grew 76 percent in comparison to the prior fiscal year, but it decreased 88 percent on a consolidated basis (Nihon Keizai Shimbunsha 1997, 168-70). Return on equity (ROE) can also vary significantly between the parent-only and consolidated company, with Dowa Mining's parent-only ROE being only 3.4 percent in 1997 but a much higher 20.0 percent on a consolidated basis. Tosoh had a parent-only ROE of 11.3 percent in 1997 but a significantly less consolidated ROE of 7.8 percent (Tokumasu and Katô 1997, 70). The earnings per share (EPS) of two department store and supermarket competitors, Daiei and Jusco, show a huge divergence when examined on a parent-only and consolidated basis. Jusco's EPS for fiscal year 1996 exceeded Daiei's by three times (49.9 to 16.8 yen per share), but Jusco's EPS was close to 80 times greater (109.1 to 1.4 yen per share) on a consolidated basis (Kawaguchi 1997).

Undisclosed Company Pension Liabilities

Japan's pension funds have a serious underfunding problem. Since Japanese companies do not need to disclose their pension liabilities, calculations of company pension liabilities can only be estimated. The size of the pension fund shortfall can be appreciated by looking at 24 Japanese companies listed on the New York Stock Exchange, which requires disclosure of pension financial information in accordance with US GAAP. These 24 companies reported 7.9 trillion yen in total pension liabilities but only 4.5 trillion yen in pension fund assets for fiscal year 1996, which means they have set aside less than 60 percent of the funds needed to pay retiree benefits (Tokumasu and Katô 1997, 103-4). The estimated pension underfunding for all listed companies in Japan exceeds 80 trillion yen, and there are estimates that about one tenth of Japanese

companies will have negative equity when they disclose their underfunding amounts (Komiya 1999, 25; *Nikkei Business* 1999, 24).

Pension fund shortfalls have arisen for two primary reasons. Many pension funds have hidden losses because the current market value of fund assets has fallen below the book value recorded at cost. Also, pension funds have suffered losses since actual yields have fallen short of expected returns on pension plan assets. Japanese pension funds have typically used an actuarial assumption that assets would earn 5.5 percent annually based on guidance from the MOF and the Ministry of Health and Welfare and based on a Corporate Income Tax Law regulation that the assumed return be at least 5 percent. However, actual returns for most pension plans have fallen below 5.5 percent since about 1991. For example, in early 1998, about 75 percent of pension assets were invested in domestic fixed income financial instruments with yields ranging from 0.5 to 2 percent. Pension funds have long been restricted by the government's 5:3:3:2 rule, which requires funds to have a pension asset portfolio composition of 50 percent minimum in assets with guaranteed yen principal value such as Japanese government long-term bonds, and maximums of 30 percent in domestic stocks, 30 percent in foreign-currency-denominated assets, and 20 percent in real estate (Beason and James 1999, 128-9; Miyake 1998). The restriction to hold a majority of pension fund assets in low-interest domestic bonds has made it exceedingly difficult for pension fund managers to achieve returns of 5.5 percent. The portion of the estimated pension funding shortfall attributable to the use of unrealistic expected rates of return for pension assets is estimated to be about 20 trillion yen (Yamashita 1999, 19).

Weak Auditing Practices

Just as Japan's accounting standards have some major shortcomings as discussed in the previous section, the country's auditing system and practices also suffer from several weaknesses. Throughout the 1990s, CPAs and statutory auditors have failed in many cases to identify and disclose financial statement window-dressing and fraudulent acts by company management and employees. Foreign companies have great dissatisfaction with Japanese CPAs since published financial statements lack credibility (*Nikkei Business* 1998a, 39). This section examines four reasons why Japan has weak auditing practices.

Company's Close Relationship with CPA Firm

A Japanese company and its CPA auditing firm usually maintain very close relations in good times and bad, so the company expects the auditor to provide help when troubles arise. Although stockholders officially select the company's CPA auditing firm, in reality the company nominates the CPA firm beforehand, and changes in a company's auditor rarely occur. This long, close relationship can lead a CPA firm to overlook and condone improper accounting used by a company to window-dress its financial statements. Auditors have been reluctant in the past to press companies to not use improper accounting because of fear their clients may leave them if they get the reputation of not providing help to a company in need (*Shûkan Tôyô Keizai* 1999b, 60).

Few Shareholder Lawsuits

Lawsuits and compensatory damage claims against CPA firms rarely occur in Japan, and no lawsuit of this type has been successful. However, recently shareholders of Yamaichi Securities sued company management and the external auditors, Chuo Audit Corporation, in multiple claims totaling over 400 million yen for losses incurred as a result of the collapse of the company because of Chuo's alleged role in concealing losses. Asahi Audit Corporation has been named as a codefendant in a claim of 86 million yen for having responsibility for the audit of Japan Housing Finance Corporation, a *jûsen* company (non-bank subsidiary of financial institution specializing in housing loans) that reorganized due to excessive non-performing loans (*Nikkei Business* 1998b, 42; Sakuma 1999, 17). The paucity of shareholder lawsuits against Japanese auditors stems from the strict legal requirement that an investor has the burden of proof to show a cause-and-effect relationship between an auditor's improper report and the investor's loss due to a drop in a company's stock price. MITI's Industrial Structure Council proposes that the system be changed so that a CPA firm has the burden to prove no cause-and-effect relationship exists between a auditor's report and a drop in the company's stock price. The Council also recommends that class action shareholder lawsuits against CPAs be permitted. If such changes were realized, suits against auditors of bankrupt companies would likely greatly increase (*Nikkei Business* 1998a, 39).

Statutory Auditor's Lack of Independence and Qualifications

The position of statutory auditor in Japan has a long history dating back to the CC enacted in 1890. The CC and SEL require a company's statutory auditor to review the company's financial statements and to verify the adequacy of internal controls, but the statutory auditor's professionalism and credibility are questionable since the law does not require specific qualifications, such as accounting or auditing education or experience, for the position of statutory auditor. In 1993, the CC was amended to require a large company to have at least three statutory auditors, with at least one of them being a person not employed by the company or any of its affiliates within the prior five years. However, even with this requirement, insiders continue to dominate statutory auditor positions, with a company very easily able to nominate 'outside' candidates who will suppress their own opinions and follow the company's direction. The majority of these so-called 'outside' statutory auditors come from the ranks of former company directors or employees or from the company's correspondent banks (Ishida 1998, 16-9; Sangyô Seisaku Kyoku 1998; Shibata Hideki 1999, 66; Tokumasu and Katô 1997, 171).

Limited Number of CPAs

Japan has few CPAs when compared to the size of its economy. Japan has only 12 thousand CPAs in comparison to 330 thousand in the US (Yokoyama 1999b). The MOF's control of the CPA examination has led to extremely low pass rates. Between 1995 and 1998, the pass rate has been below 7 percent, resulting in only about 700 new CPAs each year (JICPA 1999). Cooke (1994, 47) argues that the government keeps both the Japanese accounting and legal professions small since a large number of highly mobile professionals violates the cultural value of company loyalty.

B. Internationalization and Innovation

In addition to the accounting and auditing weaknesses examined in the previous part, the internationalization of capital markets and accounting standards and the rapid innovation in financial markets have also played a major role in the development of new accounting standards in Japan.

Globalization of Investing and Financing

Capital markets have in recent years become increasingly internationalized. After the Japanese government removed restrictions on banks' overseas financial activities through an amendment to the Foreign Exchange Law in 1980, large Japanese companies increasingly raised funds through the issuance of bonds on international capital markets. The amount of overseas bonds issued by non-financial corporations increased rapidly from 0.2 trillion yen in 1980 to 2.3 trillion yen in 1985 to 9.5 trillion yen in 1989, with a slight decrease in the early 1990s after the bursting of the bubble economy (Aoki, Patrick, and Sheard 1994, 9). International bondholders and other creditors demanded that Japanese companies present consolidated financial statements on par with US GAAP or other generally accepted international standards of accounting.

The 1985 Plaza Accord exposed Japanese companies and the financial system to global market forces and principles, and the strengthening of the yen and increased cost of doing business domestically caused Japanese companies to increase overseas production and investment. The overseas production ratio⁶ of Japanese companies increased nearly four times from 3.0 percent in 1985 to 11.6 percent in 1996 (Tsûsan Sangyô Shô 1998, Ch. 4, Par. 1). These expanded overseas activities have heightened Japanese companies' awareness of the higher-level accounting standards required in other countries.

Foreign investors, accustomed to greater transparency of financial disclosure in other industrialized countries, have found difficulties when reviewing financial statements of Japanese companies. A 1995 survey of 145 foreign banks and brokers operating in Japan found that 'inadequate public disclosure by financial firms' was one of the principal reasons for dissatisfaction with Tokyo as a financial market (Hartcher 1998, 180).

International Accounting Standards (IASs)

The development and growing acceptance of International Accounting Standards (IASs) have put much pressure on Japan to reform its financial reporting rules and practices. In response to the increasing internationalization of investing and financing as discussed above, the international financial community has called for harmonization in accounting and financial reporting practices between countries. Harmonization provides comparable information on companies throughout the world and increases the

⁶ The overseas production ratio is defined as the ratio of the sales of Japanese manufacturers' overseas subsidiaries to domestic sales by Japanese corporations.

compatibility of accounting practices by setting bounds to their degree of variation. In 1973, nine industrialized countries formed the International Accounting Standards Committee (IASC), an independent, private-sector organization, to improve and harmonize financial reporting by the issuance of IASs that address key topics affecting the financial statements of business enterprises. The organization has grown rapidly to a current membership from about 80 countries.

Although the JICPA was one of the nine founding members of the IASC and has agreed to harmonize its rules with IASs, until 1997 the BADC had taken few steps to harmonize its accounting standards with IASs. Only one Japanese company (Sasebo Heavy Industries) in the early 1990s prepared financial statements consistent with IASs, and by October 1997 the number of companies reporting with IASs had increased to only seven (Cooke 1994, 50; Yokoyama 1999c).

The stock exchanges in many countries accept the IASs for cross-border listings, with Japan and the US being the principal exceptions. For example, the London Stock Exchange has accepted IASs for over 20 years. Although the US does not accept IASs for cross-border listings, the US SEC requires companies to use US GAAP, generally considered to be as rigorous as IASs, or at a minimum to present a reconciliation of their financial statements to US GAAP.

The IASC has been working for several years with the International Organization of Securities Commissions (IOSCO), who represents the world's securities markets regulators including the MOF. IOSCO has been working to obtain agreement on a set of accounting standards that can be used to prepare reliable, high-quality financial statements that will satisfy the listing requirements in different countries. In 1995, the IASC agreed with IOSCO to complete a core set of accounting standards to be used for cross-border listings (Kino 1999, 90). The IASC finished the core set in 1998 through the issuance of new standards and the revision of existing standards in order to make them more comprehensive and to eliminate certain optional accounting treatments.

Financial Market Innovations

The need of companies and financial institutions to hedge against interest rate and exchange rate fluctuation risk by using derivatives has increased with economic internationalization and financial market deregulation. During the past two decades, rapid innovation in global financial markets has led to a dramatic increase in the types

and uses of derivative financial instruments such as options, swaps, and futures. Combinations of derivative instruments to produce specific payoff patterns have become more prevalent, and users have spread to all sizes of financial institutions and non-financial companies. Global over-the-counter (OTC) derivative transactions in 1995 reached US\$40.7 trillion in notional amount and US\$1.7 trillion in market value, with Japan's activity being 20 percent of the worldwide notional amount and 37 percent of the global market value. Derivatives traded on exchanges totaled about 40 percent of the OTC activity, and Japan's exchanges constituted about one quarter of the worldwide total (Kusumoto 1997, 200).

The complexity of many derivative instruments has led to calls for greater transparency in financial reporting to ensure financial statement readers understand the purpose and risk structure of a company's derivatives. Accounting standards in Japan for derivative instruments have developed slowly. Japanese companies have been required to provide little detail information to shareholders regarding risk exposures, use of derivatives to address these exposures, market values of derivatives, or the quantification of a firm's potential gain or loss from hypothetical changes in market rates or prices.

C. Big Bang Financial System Reforms

Japan's position as a major financial market has rapidly declined in the 1990s. The Tokyo Stock Exchange's share of global stock trading dropped to 17 percent in 1995 from 41 percent in 1990. In contrast, after Great Britain initiated its financial Big Bang plan in 1986, the London Stock Exchange's share has shot up from 5 percent in 1985 to 17 percent in 1990 to 23 percent in 1995 (Katayama 1997).

Prime Minister Hashimoto announced major financial system reforms in November 1996 to counteract this decline in Japanese financial markets. Some Japanese government officials recognized the urgent necessity of reforms as they witnessed the continuing bad loan crisis of Japanese financial institutions throughout the 1990s and several financial-related scandals and bankruptcies. The first two parts of this section examine the bad loan crisis and the financial-related scandals and bankruptcies. The third part looks at the announcement and implementation of the financial system Big Bang.

Bad Loan Crisis

During the bubble economy from 1985 to 1989, banks extended a large amount of credit with land or buildings as collateral. When the stock and real-estate bubble burst in 1990, financial institutions were exposed to significant amounts of non-performing loans.

Throughout the 1990s, the MOF delayed recognition of banks' bad loan losses and expressed reluctance to take actions against troubled or insolvent financial institutions. For example, the collapse of the bubble economy especially hurt *jûsen* companies (financial institution subsidiaries concentrating in real estate lending), but the MOF allowed the *jûsen* to hold bad loans without special write-offs even though the Ministry had made examinations in 1991-1992 that revealed 67 percent of the *jûsen*'s loans were already non-performing. With a plan to address the *jûsen* problem predicated on an increase in land prices, the MOF permitted various accounting practices that delayed or concealed reporting the effect of land and stock price declines on the value of reported assets. The extent of the problem did not finally get reported until August 1995, when 9.6 trillion yen of the total 13 trillion *jûsen* loans were considered non-performing, with 6.4 trillion yen deemed completely unrecoverable (Cargill, Hutchison, and Itô 1997).

Japanese companies' non-transparent financial reporting and the international financial market's perception of the high risk of Japanese companies have led to the 'Japan premium', which is additional interest Japanese companies must pay in order to borrow money in international markets. After three major Japanese financial institutions declared bankruptcy in November 1997, this premium exceeded one percent in December 1997 and remained over 0.5 percent for several weeks (Hall 1998, 186).

Beason and James (1999, 84) note that the opaqueness of Japanese financial reporting, compounded by the MOF's unwillingness to disclose the magnitude of the crisis, helped fuel unrealistic and irresponsible estimates of the magnitude of Japan's bad debt problem. However, the government seems to have realized that realistic reporting is preferable to unfounded speculation. The Bank of Japan's Deputy Governor (Fujiwara 1999) now admits the financial reporting weaknesses of the past:

. . . the dominant view used to be that 'disclosing the amount of non-performing loans required careful consideration because it might induce disturbance in the financial system'. In addition, the

accounting systems and practices tended to obscure the real business condition of financial institutions. Such circumstances increased the lack of transparency with respect to the management of financial institutions, and, accordingly, accelerated the deterioration in the credibility of Japan's financial system as a whole.

Financial Scandals and Bankruptcies

Lax disclosure rules allowed financial institutions and other companies to hide questionable transactions and to conceal losses and contingent liabilities. Wide-scale financial scandals and bankruptcies throughout the early and mid 1990s put great pressure on the Japanese government to reform financial reporting rules and strengthen governmental financial supervision. Even after Prime Minister Hashimoto called for financial system reforms in November 1996 and the BADC announced several significant accounting reforms in June 1997, the scandals and bankruptcies continued since most of the announced reforms had not yet been implemented. This increased the pressure on the Japanese government to hasten implementation of changes to the financial system and financial reporting regulations.

In 1991, several Japanese securities firms, including the Big Four (Nomura, Daiwa, Nikko, and Yamaichi), admitted to the illegal practice of compensating favored clients for stock trading losses totaling up to 173 billion yen, in addition to other improper activities such as tax evasion and ignoring MOF directives. The Japanese Fair Trade Commission issued decrees against the Big Four securities firms ordering them to promise never to compensate clients for losses again and clearly stating that repeat offenses would lead to criminal sanctions (Hall 1998, 43; Taka 1996). However, the illegal compensation persisted after 1991, especially at Yamaichi Securities.

Thirteen Japanese financial institutions went effectively bankrupt during 1995. The magnitude of the bad loans at the failed institutions turned out to be much worse than previously reported. For example, Cosmo Credit Cooperative's 2.4 billion yen of non-performing loans reported prior to the institution's failure rose to 350 billion yen, and Kizu Credit Cooperative's previously disclosed 32 billion yen in bad loans grew to 800 billion yen. The financial institutions understated the extent of their non-performing loans by a combination of illegal fraud and of accounting trickery designed to produce misleading financial numbers but allowed under the loose disclosure requirements in place at the time (Ozaka 1998, 28-9; Schaefer 1996).

Daiwa Bank disclosed a loss of US\$1.1 billion due to unauthorized trading of US Treasury bonds over 11 years by an individual trader in its New York branch, which resulted in the resignation of the bank's top officials in October 1995, an order to close its US operations by February 1996, and a fine of US\$340 million. Daiwa Bank pleaded guilty to misleading US bank regulators and obstructing justice by an attempted cover-up. The MOF ended up admitting after previous denials that it knew about the undisclosed losses six weeks before notifying US authorities (Hall 1998, 45-6).

In June 1996, Sumitomo Corporation announced that it had uncovered about US\$1.8 billion (later adjusted upward to US\$2.6 billion) in unreported losses related to unauthorized trades of copper futures by one of its employees. Sumitomo disclosed that the trader falsified books and records to conceal the unauthorized trades, but the competence and integrity of Japanese corporate management, as well as the adequacy of external supervision and audits, were again called into question by international financial market participants (CNNfn 1996a, 1996b; Hall 1998, 46).

The life insurance industry also experienced problems when stock prices dropped in the early 1990s. They had promised to pay policy holders annual returns of about 5 percent, but the major life insurance companies' returns on their investments in 1994 ranged from 1.3 to 3.5 percent, resulting in a negative spread. In April 1997, Nissan Life declared bankruptcy with its liabilities exceeding assets by more than 300 billion yen primarily due to previously undisclosed valuation losses on securities the company held. The MOF had received financial reports from Nissan Life for four years prior to bankruptcy which showed the company's negative capital position if hidden securities losses were included, but the company continued to solicit new insurance policies and make payments to existing policy holders since the MOF did not make public the company's precarious financial condition (Hartcher 1998, 160; *Nihon Keizai Shimbunsha* 1997, 154, 159; Ozaka 1998, 90-1).

In March 1997, Nomura Securities, the largest brokerage firm in Japan, admitted to making illegal payoffs to *sōkaiya* (corporate racketeers) to ensure they did not interrupt shareholders' meetings with embarrassing questions to company management. The firm also confessed to compensating preferred clients for trading losses. In addition to certain punitive actions, the MOF required implementation of a plan to improve compliance with laws and regulations, reinforce internal controls, improve internal operating procedures,

and terminate all relationships with *sôkaiya*. As a result of the scandal, Nomura's president and 15 board members resigned, and the firm lost several key customers. Daiichi Kangyo Bank, Daiwa Securities, Nikko Securities, and Yamaichi Securities also suffered from MOF financial penalties and the loss of corporate customers as a result of payoffs to *sôkaiya* (Hall 1998, 44-5).

The scandals and bankruptcy of Yamaichi Securities, the fourth largest securities company in Japan, exemplifies the weaknesses in Japanese financial reporting and regulation. Yamaichi did not disclose significant off-the-book debts for several consecutive years, with the amount finally reaching more than 275 billion yen. The majority of these liabilities resulted from Yamaichi's guarantee of a minimum rate of return to favored customers and then illegally compensating them for any shortfall. In order to avoid disclosing significant losses on these liabilities, Yamaichi engaged in the illegal practice of *tobashi* in which they temporarily shifted their investment losses to another company's or client's books through repurchase agreements based on non-market prices. Yamaichi executed *tobashi* transactions with companies having fiscal years ending on a different date and with affiliated 'paper companies' that Yamaichi established specifically for this purpose and did not include in its consolidated financial statements (Ozaka 1998, 31-2; Shibata Hideki 1999, 241; Shôken Torihiki tō Kanshi Inkaï 1998). Yamaichi Securities declared bankruptcy in November 1997. In the same month, Hokkaido Takushoku, Japan's tenth largest bank, and Sanyo Securities, the seventh largest securities firm, also discontinued business.

In a survey (Keizai Kôhō Sentô 1997), company employees throughout Japan gave the reasons why company scandals occur. The top four reasons⁷ given were (1) a company environment where it is difficult to point out a problem even when one exists (54 percent), (2) lack of awareness by management (53 percent), (3) unclear company ethics and standards of conduct (37 percent), and (4) lack of systems for checking within the company (34 percent). When asked what should be done to prevent reoccurrence of scandals, the top two responses were improvement of the company environment so that employees could point out a problem when one exists (58 percent) and implementation of a system of checking within the company (48 percent). The results of this survey indicate that increased disclosure requirements and audit reviews to prevent financial scandals

⁷ Survey participants could give up to three responses.

may have limited effectiveness due to a company environment established by management that does not encourage problem disclosure and that does not clearly prohibit unethical and questionable actions.

Big Bang Announcement and Implementation

In response to the financial system weaknesses described in the previous sections, Japanese Prime Minister Hashimoto announced plans in November 1996 to accelerate and broaden financial reforms by creating ‘free, fair, and global’ markets. He called these reforms the Japanese Big Bang based on its similarity to Britain’s 1986 Big Bang, which propelled the London Stock Exchange to increase its share of global stock trading nearly five times over the next ten years by deregulating the stock market, abolishing fixed commissions on securities transactions, and opening the stock market to foreign firms. Japan’s Big Bang will not be restricted to the stock market but rather will encompass all financial markets in addition to significantly affecting non-financial companies in such areas as financial reporting and foreign exchange controls.

A principal objective of the reforms is to turn Tokyo into a world class financial center on par with New York and London. Japan’s financial system Big Bang will break down barriers between banks, insurance companies, and securities firms; liberalize brokerage commissions and foreign exchange laws; reform the corporate accounting system; open the doors to foreign competitors and new financial products; and institute other measures to deregulate financial markets.

The principles of ‘fair’ and ‘global’ directly relate to financial reporting, and Prime Minister Hashimoto (1996) explained that ‘global’ covers the internationalization of accounting standards and that ‘fair’ covers full disclosure to protect investors and to achieve transparent, reliable markets. He called for thorough disclosure at all levels, from business accounting to government administration, to ensure fair markets, and he urged changes to the legal system related to derivatives as part of achieving an improved international financial market.

The Prime Minister instructed his Minister of Finance and Minister of Justice to immediately begin examining financial system reform and complete its implementation within five years. In response to Prime Minister Hashimoto’s direction, the two

Ministers directed the BADC, Securities and Exchange Council, the Financial Systems Research Council, the Insurance Council, and the Committee on Foreign Exchange Transactions to formulate plans for reform measures to be completed by 2001. In June 1997, these councils presented their recommendations for specific reforms with a schedule for implementation.

The Securities and Exchange Council's report (Shôken Torihiki Shingikai 1997, IV 2 (6)) called for full and transparent disclosure through consolidation and fair-value accounting principles in order to provide investors sufficient information to properly assess the risk and return of potential investments. The Council also urged the improvement and strengthening of the review by CPAs in order to improve corporate governance. Recognizing the need for investors to easily obtain disclosed information, the Council advocated providing information through the Internet.

As a result of the MOF's delayed response to address the bad loan problem and the improprieties of MOF bank inspectors reported in early 1998, the Diet approved establishment of the Financial Supervisory Agency (FSA), a governmental body independent of the MOF and reporting directly to the Prime Minister's Office. The FSA began operations in June 1998 by taking over from the MOF the regulatory functions of supervision and examination of private-sector financial institutions, with the MOF continuing to be responsible for planning and formulating policies for the financial and securities system. The MOF's other responsibilities, such as control of corporate financial reporting requirements and administration of the SEL, remained the same.

III. Critical Evaluation of Accounting Reforms

In response to Prime Minister Hashimoto's call for financial reporting reforms, the BADC reorganized in February 1997 by designating the Accounting Division to work on a new standard for consolidations and by setting up special groups to deal with corporate pensions, financial instruments, and R&D costs. The BADC took into account international harmonization when establishing new standards or revising existing ones, and the Council carried out research into accounting practices in other major industrialized countries, as well as International Accounting Standards (Maki 1997, 70).

In the one-year period between June 1997 and June 1998, the BADC issued more accounting opinions than in the previous ten years (Hiramatsu 1998, 25).

In the new accounting standards, the BADC pointed out the need for reform of Japan's financial reporting system in order to enable investors to make better informed decisions based on a more accurate representation of a company's financial condition and operating results. The new standards also specifically mention the objectives of promoting the participation of foreign and domestic investors in Japan's securities markets and of establishing a disclosure system on par with international standards and based on consolidated financial statements (Kigyô Kaikai Shingikai 1997a, 1999).

In June 1997, the BADC issued accounting opinions on consolidated financial statements, financial instruments (interim report), income tax accounting, cash flow statements, R&D costs, and interim financial reporting. The BADC published its pension accounting standard in June 1998 and its final version of the financial instruments accounting standard in January 1999.

This chapter critically examines these recent accounting changes and their effects. Part A analyzes the revisions in the three key areas of consolidations, fair-value accounting, and pension accounting. Part B explores the responses of companies to the accounting changes. Part C points out several weaknesses in Japan's financial reporting system that will remain after complete implementation of the Big Bang financial reforms and the accounting standard changes.

B. Examination of Accounting Changes in Three Major Areas

The new accounting standards issued between 1997 and 1999 have drastically changed the rules by which companies must report their financial condition and operating results. Although this section only reviews the changes made in the three major accounting areas of consolidations, fair-value accounting, and pensions, the BADC issued new standards in other significant areas of accounting. For example, R&D costs now must be reported as current period expenses, with companies no longer having the option to defer the reporting of expenses by capitalizing R&D costs.

Consolidations

The BADC issued in June 1997 a new standard on consolidated financial statements, which requires that a company's extent of control or influence, rather than only the previously used shareholding percentage, be used as an additional criterion to

determine whether a subsidiary must be included in the consolidated financial statements or whether the equity method of accounting must be applied to affiliates. These changes in consolidation accounting rules took effect for the fiscal year ending March 31, 2000. Consolidated financial statements replace single-entity financial statements as the main financial reporting in annual securities reporting as well as registration statement reporting under the SEL (Ishida 1998, 16; Kigyô Kaikei Shingikai 1997b).

When the new rules take effect, Japanese parent companies will be forced to make decisions based on their effect on the entire business group, and they will have great difficulty carrying out transactions with non-consolidated subsidiaries and affiliates such as executing *tobashi* transactions to hide troubled assets, increasing sales and profits through intercompany transactions, and transferring excess personnel.

Some limited consolidation reporting requirements went into effect before fiscal year 1999. The new rules on consolidations required companies to disclose contingent liabilities on a consolidated basis starting for fiscal year 1998. The MOF also required a consolidated marketable securities report starting for fiscal year 1997.

The 1997 BADC standard on consolidation accounting expands the number of subsidiaries required to be consolidated, and the BADC issued a statement in October 1998 with more specific guidance to determine whether a parent company has effective control of a subsidiary or can substantially influence an affiliate's decision making. A parent company must use consolidation accounting for an entity in any of the following situations (Kigyô Kaikei Shingikai 1998a; Yoshii 1999a, 63):

- (1) Parent company holds more than 50 percent of other entity's voting shares of stock (with limited exceptions such as a bankrupt entity that the parent company no longer effectively controls)
- (2) Parent company holds between 40 and 50 percent of voting shares and one of the following conditions is met:
 - a. More than 50 percent of other entity's voting shares held by parent company and other companies with a close relationship to parent company through investment, personnel, technology, business transactions, or other factors
 - b. Majority of other entity's board of directors made up of current or former employees of parent company

- c. Parent company controls important financial or operating policies of other entity (for example, through franchise, license, technical assistance agreement, or subcontracting relationship)
 - d. Majority of other entity's liabilities provided by loans (including loan guarantees and collateral) from parent company or closely related companies (see definition above in (2)a.)
 - e. Existence of other factors that indicate parent company controls other entity
- (3) Parent company and closely related companies (see definition in (2)a.) hold majority of voting shares and one of conditions from (2)b. to (2)e. is met.

The new rules on consolidations also cover the determination of affiliated companies subject to the equity method of accounting. Rather than use of a strict 20 to 50 percent ownership criterion to determine when equity accounting should be applied, the new standard requires that the ability to substantially influence an entity's decision making also be considered when determining whether the equity method should be applied to affiliated companies. Specifically, a parent company that owns 15 to 20 percent of an entity and meets one of five specified conditions must apply the equity method to the entity's earnings (Kigyô Kaikai Shingikai 1998a).

The new accounting standard on consolidations will significantly increase the number of subsidiaries that parent companies will be required to consolidate. For example, Tôkyû Dentetsu will increase the number of consolidated subsidiaries from about 200 to 300 (Komiya 1999, 25), and Kawasaki Steel will expand the number of consolidated subsidiaries nearly four times to 200 starting in the fiscal year ending March 31, 2000 (*Nikkei Kin'yû Shimbun* 1999a, 1).

The 3-5 percent materiality rule for non-consolidation of subsidiaries and for non-inclusion of the parent company's share of affiliated companies' net income still remains in effect (Kawamura 1999a, 7 September; Ôta 1998, 80), which means corporations still have an opportunity to intentionally exclude certain subsidiaries and affiliates from their financial statements. In contrast, American and European companies consolidate all subsidiaries as a common business practice (Shiratori 1998, 182, 196-7).

Fair-value Accounting

In June 1997, the BADC officially announced that fair-value accounting would be introduced for financial instruments. The Council disclosed they would address issues such as how changes in fair value would be reflected in the financial statements, the scope of financial instruments subject to fair-value accounting, and accounting recognition for derivatives (Kigyô Kaikai Shingikai 1997a).

In January 1999, the BADC completed its new standard for financial instruments. The accounting for changes in fair value differs depending on the type of security, and the following section summarizes the basic rules (Kigyô Kaikai Shingikai 1999):

- (1) Trading securities are measured at their fair value, and any unrealized gains and losses are included in earnings reported on the income statement. Trading securities include stocks and debt securities held principally for resale in the near future with the objective of generating short-term profits.
- (2) Debt securities that management intends to hold to maturity are measured at amortized cost⁸, so a company does not report gains and losses for changes in market value.
- (3) Subsidiary or affiliate stock held by a parent company is reported at historical cost. In consolidated financial statements, the parent company consolidates the assets and liabilities of subsidiaries and applies the equity method of accounting to affiliates.
- (4) Available-for-sale securities include investments in securities not classified as (1) to (3) above. A company may hold these securities for maintaining relations with the invested entities or may hold them for selling depending on market conditions. This category of securities includes cross-shareholdings so common among Japanese businesses. A company must measure these securities at fair value, but unrealized gains and losses are reported in a section of shareholders' equity on the balance sheet rather than in earnings on the income statement.

The new accounting rules still require recognition of losses even for securities carried at historical cost if the fair value of the securities declines significantly and if the decline is judged not to be temporary. The new standard also requires the measurement of

⁸ Amortized cost represents historical cost with an adjustment for any applicable amortization of a premium or discount as part of income for the period.

derivative financial instruments at fair value, and gains or losses from derivatives must be reported on the income statement (Yoshii 1999b, 145).

The BADC's new comprehensive standard on financial instruments covers several other topics. One section addresses deferral of gains and losses on financial instruments used to hedge against such market risks as exchange rate, price, or interest rate changes. Another section gives guidelines on estimating loan losses by categorizing loans into three groups: normal, doubtful, and failed.

The new rules on accounting for financial instruments do not go into effect until fiscal years beginning on or after April 1, 2000. The full implementation of the rules for reporting gains and losses on available-for-sale securities has been deferred even further to one year later. The Keidanren strongly argued for this deferral because they believe the effects of suddenly recording cross-held stock at fair value would be too great in this current period of depressed stock prices, and companies need time to implement strategies to get rid of certain cross-stockholdings (Murakami 1998, 26; *Nihon Keizai Shimbun* 1998, 17).

BADC Chairman Wakasugi (1999b, 17) says it was important to first introduce fair-value accounting in whatever form, but he believes the lack of consistency in reporting gains and losses for different types of stocks will probably lead to criticism from overseas. He personally believes that fair-value accounting should be applied to all types of stocks to prevent company management from having the ability to significantly control reported profits. In addition, Wakasugi supports reporting all gains and losses on the income statement rather than recording gains and losses on available-for-sale securities directly to the equity section on the balance sheet. In contrast, the Keidanren criticizes the method of reflecting market valuations of stocks on the income statement, saying 'it's strange to have business results influenced by market price levels not connected with management's efforts' (*Nikkei Business* 1997a, 93).

Lax reporting standards have made it difficult to do a true accounting of the amount of non-performing loans held by Japanese financial institutions, but the government finally adopted a broader definition of bad loans for financial institution reporting as of March 1998. The new regulations require a wider range of disclosure of actual and

potential non-performing loans, similar to standards required by the US SEC. For example, past due loans in arrears by three months or more must now be reported as a bad loan, whereas the previous rules used a less stringent criterion of six months or more. The FSA reported 35 trillion yen as the estimated total of bad loans for all financial institutions as of March 1998, whereas the amount would have been only 25 trillion yen under the previous reporting rules. In addition, the FSA also disclosed 66 trillion yen of loans requiring close monitoring and risk management to ensure they do not become non-performing (Kin'yû Kantoku Chô 1998b). However, the estimate of 35 trillion yen still turned out to be low, with the Japanese government spending about 70 trillion yen through May 1999 to cover the losses incurred by financial institutions disposing of non-performing loans (Fujiwara 1999).

Although the new accounting rules require fair-value accounting for some financial instruments, companies still do not have to disclose the fair value of their land holdings and other fixed assets.

Pension Accounting

The BADC issued in June 1998 its opinion on accounting for pension benefits, which will go into effect for fiscal years beginning after March 31, 2000 (Kigyô Kaikei Shingikai 1998b). This pension accounting standard requires the recording of pension costs and liabilities on an accrual basis, which means companies will record pension expense regardless of the contributions they make to the pension fund. Companies must determine the net pension liability (or asset) to be recorded on the balance sheet by using fair-value accounting for pension fund assets and by employing present-value actuarial calculations on the pension liability. Unrecognized prior service cost⁹ at the date of implementation of the standard must be recognized as expense over a maximum of 15 years. These changes generally bring Japanese pension accounting into line with international accounting standards and will enable meaningful comparisons between Japanese companies, although some minor differences exist such as the IAS requiring a

⁹ Unrecognized prior service cost can be defined as the difference between the accumulated pension obligation, which is the actuarial value of benefits earned from employee service to the implementation date of the accounting standard, and the portion of the obligation not yet recognized as pension expense.

maximum of five years for amortization of prior service cost rather than the less stringent 15 years allowed by the BADC standard.

The new pension accounting standard provides a hardship exception that allows companies to extend implementation until fiscal years beginning after March 31, 2001. The standard states the exception applies to companies with hardships in applying the standard by the required date because of problems in arranging for actuarial services (Kigyô Kaikei Shingikai 1998b, Section 5.1). However, companies must still publish the pension liability and other details in their financial statement footnotes for fiscal year 2000, even though they are not required to reflect the pension liability on the balance sheet and pension expense on the income statement.

For fiscal years 1998 and after, the Ministry of Health and Welfare permitted more flexibility in setting an expected rate of return on pension plan assets. Rather than mandating a 5.5 percent return, the Ministry allowed more flexibility in setting the expected return by allowing each fund to choose a rate between an upper limit of 6.5 percent, which will expire after fiscal year 2001, and a lower limit based on the average interest rate of ten-year government bonds issued in the prior five years (Imafuku 1998a, 217). The previous minimum 5 percent return specified by a Corporate Income Tax Law regulation was also reduced, and the minimum rate in 1999 is 1.5 percent (Kawamura 1999a, 9 October). The use of a lower interest rate to calculate a company's pension liability leads to a more realistic and higher annual pension contribution and expense.

B. Effects of Accounting Changes

The recent accounting changes are having a profound effect on Japanese companies. This part discusses the reactions and responses of companies to the BADC's significant accounting changes announced from 1997 to 1999.

Corporate Restructuring

The recent accounting changes have hastened the restructuring of many Japanese companies wanting to improve their operating results to be reported under the new rules. The Japanese business press has reported various strategies being used by companies since 1997 to address the impact of the new accounting standards. These strategies include sales of land with market value higher than book value in order to offset losses in marketable securities; conversions of hidden profits in stock to cover asset value writedowns and severance payments related to restructuring; and plans to sell,

consolidate, liquidate, and restructure divisions and subsidiaries, especially those that will not contribute to profitability measured on a consolidated basis (for examples, see *Nihon Keizai Shimbun* 1999a, 1; 1999c, 13; *Nikkei Business* 1997a, 91-2; *Nikkei Kin'yū Shimbun* 1999b, 23; Shioda 1999, 59-60).

Itô (1998, 30) comments that the introduction of the new accounting standards will have severe impact on corporations' reported financial results and near-term employment for two reasons. First, most companies' stockholders' equity and assets will expand with the implementation of fair-value accounting, which will cause their return on equity (ROE) and return on assets (ROA) to fall. Institutional investors will not permit this, so companies will have no other choice but to generate profits by selling their cross-held stock so their ROE or ROA does not drop. Second, company groups will not be able to avoid restructuring since the new standards force them to consolidate the results of some poorly performing companies not previously consolidated. A March 1999 survey by the *Nihon Keizai Shimbun* found that leading OTC companies believe the requirement for consolidated disclosures is the change that will impact them the most (Hara 1999, 17). The new BADC consolidations standard will put pressure on employment in the short-term as company groups seek to restructure before the end of their fiscal year at March 31, 2000, when the new consolidation accounting rules must be applied.

With Japanese companies' divestitures of unprofitable business units and subsidiaries and with the dismantling of barriers to foreign acquisitions as part of the Big Bang financial system reforms, acquisitions of Japanese firms by foreign companies increased over six-fold from US\$1.1 billion in 1997 to US\$6.9 billion in 1998, although Japan still has an extremely low share of the total 1998 international M&A activity of US\$544 billion (KPMG 1999). Shibata Yōko (1998, 44) explains that recessionary conditions have led to M&A growth in Japan, but 'changes in accounting regulations are playing an even more important role' as companies will no longer be able to hide unprofitable subsidiaries and affiliates, which creates a powerful incentive to sell these companies.

Japanese companies will be pressured by investors to shed stocks in subsidiaries and affiliates that do not improve their return on equity (ROE). Goldman Sachs Securities estimates that the ROE for first-tier companies listed on the Tokyo Stock Exchange will fall to 0.45 percent when they begin to record true pension expense and apply fair-value accounting to marketable securities (*Nikkei Business* 1999, 27). This

return does not even exceed the rate companies can earn in fixed-income securities, so many companies are considering seriously the sale of their stocks in underperforming *keiretsu*-related companies. Keidanren leaders have pointed out that when companies apply fair-value accounting to cross-shareholdings, shareholders' equity will greatly expand, which will cause financial indicators such as ROE to deviate greatly from international standards. As a result, a company's credit rating may fall, which will lead to problems in raising capital (Kino 1999, 91).

With the Big Bang financial reforms deregulating the Japanese financial markets and encouraging greater participation by foreign companies, several foreign financial firms have expanded their presence in the Japanese market since 1997. Large financial institutions such as GE Capital Services, Citigroup, Dresdner Bank, and Merrill Lynch have made substantial investments or have established joint ventures with Japanese companies to provide services for specific financial market segments.

Despite the recent increase in investments by foreign companies, some investors still have not been able to satisfy themselves that they have identified all company financial risks even with a detailed due diligence process. This non-transparency in Japanese financial reporting continues because the first significant accounting changes, namely those related to consolidation accounting, will not get reflected in companies' financial statements until the fiscal year ending March 31, 2000. As an example of foreign investors shying away from the purchase of Japanese companies, DaimlerChrysler expressed great interest in purchasing Nissan Diesel Motor Company in 1998, but the deal eventually fell through with a principal reason being that DaimlerChrysler had great difficulty ascertaining the amount of debt and contingent liabilities not disclosed in Nissan Diesel's consolidated financial statements. The undisclosed liabilities in Nissan Diesel Sales, an unconsolidated subsidiary owned 50 percent by Nissan Diesel, and in Nissan Diesel's 48 keiretsu-related dealers totaled at least 100 billion yen, and some industry estimates put the figure as high as 300 billion yen (Masui 1998, 94).

Revisions to Post-employment Benefits

As a result of the implementation of the new pension accounting standard, many Japanese companies are reviewing their existing post-employment benefits for possible revisions. Since companies have responsibility to make up any shortfalls between actual and expected returns on pension fund assets, they bear a large risk when they set pension benefit amounts now that will not be paid until the distant future. If management and labor do not agree on a way to reduce pension liabilities, some companies may have no other way to cover the pension reserve shortfalls than to reduce benefit amounts promised to employees, cut current wage levels, or carry out restructurings (Imafuku 1998b, 31; *Shûkan Tôyô Keizai* 1999a, 18-9).

Companies may try to reduce their future pension liabilities by moving from a defined benefit pension plan to a defined contribution pension plan like the US's 401(k) plan, which specifies the amount the company will contribute to the plan but does not guarantee or define the final benefit amounts to be received by employees. However, unlike the US's 401(k) plans, the Japanese tax system does not allow tax deferrals of contributions and investment earnings for defined contribution plans. Starting in 1999, Japan's leading temporary employment agency, Pasona, will introduce the first American-style defined contribution plan in Japan for its regular employees and for over 50 thousand of its employees contracted out to other companies. Employees may make monthly contributions from 3 to 15 percent of their salary, and Pasona will match the contribution with 1 to 8 percent of monthly salary based on an employee's seniority. Employees have the choice of several investment options varying in risk and expected return (Ueda 1998, 30). Saison Group also plans to move toward a defined contribution pension plan that will lighten the company's current burden by having pension payment amounts vary according to the plan's investment returns (*Nikkei Ryûtsû Shimbun* 1999, 1).

Several companies have decided to quickly address their pension shortfalls and to disclose pension financial information even before the required implementation of the new accounting standard. For example, Tokyo Gas will record 14 billion yen of total expenses for fiscal years 1998 and 1999 to ensure the company has already recognized the appropriate liability amount when the new standard goes into effect in fiscal year 2000. The company also has reduced its expected return on pension assets from 5.5 percent to a more conservative 4.5 percent. Toshiba decided to record a 27 billion yen extraordinary

loss for fiscal year 1998 by shortening the amortization period for prior service liability from 15 years to three years, which is the shortest period allowed by the Japanese taxing authorities to obtain a valid deduction for tax purposes. Although several large companies are addressing their pension shortfalls through additional contributions, the majority have postponed action (*Nihon Keizai Shimbun* 1999b, 5; Yamashita 1999, 19).

Since the abolishment of the 5:3:3:2 asset allocation rule by the Ministry of Health and Welfare in 1998, pension funds have been free to attempt to improve investment returns by increasing equities and foreign securities holdings rather than maintaining the majority of fund assets in domestic fixed-income securities. However, almost no funds have made radical shifts in asset weightings (Beason and James 1999, 135-7). As a result, many companies will be facing large pension liabilities when the new standard goes into effect in fiscal year 2000.

C. Remaining Weaknesses

Section III.A. pointed out several criticisms of the new accounting standards for consolidations, fair-value accounting, and pensions. Moreover, even after implementation of the new accounting changes, several other significant weaknesses in Japan's system of financial reporting and accounting will remain. This section examines areas where shortcomings will still exist: the Japanese government's unwillingness to radically change, the unchanged triangular legal system, several significant differences with international accounting standards, the MOF's control over corporate financial reporting requirements, and deficiencies in the auditing and corporate governance systems.

Government's Reluctance to Radically Change

Even though Japan has announced several significant accounting changes since 1997, questions still arise as to the strength of the Japanese government's commitment to fair, transparent, and consistent accounting. Although Prime Minister Hashimoto announced the Big Bang financial reforms in November 1996, the BADC has delayed implementation of the accounting standard changes for several years. For example, the mandatory recognition of pension liabilities and the implementation of fair-value accounting for available-for-sale securities (including cross-shareholdings) will not occur until the fiscal year ending March 31, 2002. Other financial system Big Bang reforms will not be complete until 2001, five years after the original announcement by Prime Minister Hashimoto. For example, the Japanese government continues to protect weaker financial

institutions by extending complete government guarantees for all bank deposits and other claims on banks until March 2001, and discussions have started regarding whether these measures should be extended even further (Fujiwara 1999).

The government continues to manipulate financial reporting rules for political purposes. For example, in 1998 and 1999 the government approved two major temporary changes in accounting requirements in order to provide relief for banks and insurance companies and to ensure financial system stability. First, the Diet approved amendments to allow companies to revalue land upward from cost to market value for fiscal years 1997 and 1998. This provided banks the opportunity to cover the write-off of bad loans and to improve the ratio of capital to total assets to the minimums established by Japanese banking regulations and the Bank for International Settlements (BIS). If the 19 largest banks took advantage of this rule change, the total land value recorded on their books will increase 4.3 trillion yen based on estimated market values at April 1998. The banks will be able to improve their capital ratios by about one percent on average. In addition to the revaluation exception, for fiscal year 1997, the MOF permitted banks to utilize the cost method rather than the lower-of-cost-or-market method to value stocks so they would not have to report valuation losses. However, banks had to recognize losses if the market price for a stock fell below 50 percent of the bank's book value recorded at historical cost. In prior fiscal years, the MOF had required financial institutions to value marketable securities using the lower-of-cost-or-market method, although non-financial companies were allowed to use the cost method. As a result of the relaxed rules on marketable securities valuation, 16 of 19 of the largest Japanese banks switched from the lower-of-cost-or-market method to the cost method for the fiscal year ending March 31, 1998. As of August 1998, the 16 banks using the cost method to value stocks held an estimated total of 3.2 trillion yen in hidden losses (Hiramatsu 1998, 26-9; Isoyama 1999, 19).

A top MOF official (Naitô 1999, 17), when questioned how Japan will recover its international credibility after these actions, answers that these were exceptional steps carried out for a limited time to strengthen banks' capital and to address Japan's credit crunch. He further explains that in the short term the MOF had to succeed in stabilizing the financial system, and beyond these measures the MOF will not play with the system to provide banks relief.

Triangular Legal System

Japan's so-called 'triangular legal system' obstructs Japan's push forward to internationalize its accounting standards. Wakasugi (1999a, 153-4) points out the difficulties and long time required to change the CC and the Corporate Income Tax Law to reflect new accounting standards. The CC has still not been modified to reflect the system of consolidated financial statements introduced over 20 years ago in 1977 to the SEL.

Ishida (1998, 14) contends that, from the standpoint of a company trying to follow the laws, it is desirable to implement consistent accounting treatment and disclosure that will conform to either the CC, SEL, or Corporate Income Tax Law, because the company has only one actual financial condition and results. In addition, other interested parties such as stockholders, creditors, investors, and the government would also be expected to find such consistency to be highly useful.

Although the MOF and MOJ formed a study group in 1997 to investigate coordinating the CC and the BADC accounting standards, the group made no recommendations in its 1998 report to require companies subject to the CC to comply with the new BADC standards (Shôken Kyoku 1998). The Diet did pass CC amendments in 1999 that allow companies to measure marketable securities and derivatives at fair value, cost, or the lower of cost or market. Even though the new BADC standard requires listed companies to generally measure marketable securities and derivatives at fair value, the CC continues to allow non-listed companies to measure them at cost or at the lower of cost or market. Moreover, the BADC consolidation and pension accounting requirements still only apply to listed companies subject to the SEL (Kawamura 1999a, 9 July; Maki 1997, 70)

Differences with International Standards

The BADC Chairman has made known that his aim is to make Japanese accounting standards in conformance with International Accounting Standards (IASs) (Kino 1999, 90), but several differences still remain, including the following three significant areas where Japanese accounting standards differ from both IASs and US GAAP (Kawamura 1999b; Yokoyama 1999d):

(1) The IASs and US GAAP require recognition of a loss for impairment in value of long-lived assets such as land, buildings, machinery, and goodwill arising from acquisitions. Indicators of impairment include a significant decrease in the market value of an asset or a significant adverse change in legal factors or the business climate that would affect the asset value. A company records an impairment loss when the asset's book value exceeds estimated future cash flows from the asset.

Japan lacks an accounting standard that addresses impairment in value of long-lived assets such as land or buildings. The BADC has not even begun discussion on the topic. One member of the BADC says that the implementation of impairment accounting in Japan would be terrible for businesses, since companies would fall one after another to a negative capital position if the BADC proceeds to get rid of hidden losses by implementing impairment accounting (Isoyama 1999, 19). JICPA Chairman Nakachi (1999, 32) also believes that it would be a huge blow to Japanese companies if impairment accounting were suddenly introduced into Japan, who is now economically weak.

(2) Japan's accounting standards allow inventories to be measured at acquisition cost or the lower of cost or market at the company's option. If a Japanese company uses the cost method for inventory valuation, hidden losses may result if the market value drops significantly. Although the accounting rules require a write-down in inventory value if the decline in value is not temporary, company management may judge the decline to be temporary in order to avoid reporting losses. In contrast, the IASs and US GAAP require the lower-of-cost-or-market method to value inventories.

(3) Japan also does not have a specific accounting standard that addresses changes in company accounting policies such as a change in inventory costing method or fixed asset depreciation method. Kawamura (1999b) points out that in general Japanese companies frequently change accounting policies even though accounting standards state such changes should not be made without justifiable reasons.

Ministry of Finance Control

Even after the Financial Supervisory Agency (FSA) began operations in June 1998 reporting directly to the Prime Minister's Office, the MOF remained firmly in control of

corporate financial reporting requirements, and the majority of the MOF's other powers remained intact. The MOF still controls the BADC, National Tax Administration Agency, and the JICPA. The MOF also continues to have complete responsibility for planning and policy-making for the financial and securities system. Although the FSA does not report directly to the MOF, the FSA started operations with over 90 percent of its employees from the MOF, so questions have arisen as to whether the FSA will really operate independently from the MOF (*Asahi Shimbun* 20 June 1998, 11).

BADC Chairman Wakasugi (1999b, 17) has expressed his dissatisfaction with the BADC's lack of independence due to the MOF's control over agenda topics covered by the BADC. For example, he personally thinks that impairment accounting for long-lived assets definitely should be implemented, but the BADC has no opportunity to consider what topics should be addressed next. According to Wakasugi, the MOF's explanation is that the submission from the MOF of problems to be considered has been established as the BADC's basic method of operating. He has advocated for a long time that there should be a forum to discuss from a broader viewpoint how the BADC should address issues of the entire accounting system.

Contrary to Wakasugi's opinion, a top MOF official argues that although other countries may have independent non-governmental bodies to set accounting standards, Japan's BADC is carrying out its functions well. The BADC Chairman is an independent scholar, and the Council's members are selected from a wide range of people such as CPAs, company representatives, financial analysts, and academics. 'It's different than an ordinary government Council; the BADC has strong independence. It issues exposure drafts before making a standard, and it prepares specific written opinions based on views from all interested parties.' (Naitô 1999, 17)

Auditors and Corporate Governance

Although some improvements have been made to enhance the quality of CPA audits, such as the introduction in 1999 of mandatory CPA continuing education and peer reviews performed by the JICPA to check the quality of audits by audit corporations (Yokoyama 1999a), doubts still exist as to whether CPAs will perform objective, thorough audits and will challenge company management on questionable accounting treatments.

The boards of directors of almost all Japanese companies continue to be made up entirely of executives from the company itself or from *keiretsu*-related financial

institutions and non-financial companies. Most Japanese companies lack an effective corporate governance system that makes company executives accountable to shareholders by having the board of directors critically review company strategies, monitor company top executives to prevent unlawful behavior, and dismiss top executives if necessary. A few companies have started to include outside directors and have reduced their board size to hold the directors more accountable. For example, Sony has reduced its board size from 36 to 10 with three outside directors (Ozaka 1998, 264).

The internal audit function at Japanese corporations also requires improvement to be more effective in identifying financial problems and internal control weaknesses. In contrast to the US where rigorous, technically-competent internal audits are carried out by company employees, in Japan where harmony (*wa*) is treasured as a cultural value, the lifetime employment system and seniority-based wage system established in large companies continue to present an obstacle to effective internal audits by fellow employees (Yokoyama 1999e).

Conclusion

The new accounting standards announced by the BADC between 1997 and 1999 will greatly improve the usefulness of company financial reports by providing investors, shareholders, and creditors more complete and accurate information about a company's financial situation and results. Someya (1996, 12-8) identified two accounting revolutions in Japan: the introduction of double-entry bookkeeping in the 1870s and the introduction of investor-oriented financial reporting by the Allied Command after World War II. The far-reaching accounting revisions announced between 1997 and 1999 rank at the same level as Japan's first two accounting revolutions. The changes in fair-value accounting, consolidations, pensions, R&D costs, and other areas of accounting represent fundamental shifts in the financial reporting framework. As a result of this Accounting Big Bang, numerous Japanese companies have implemented or are considering restructuring of operations, sales of cross-shareholdings, modifications to reported financial information, and revisions to pension benefits.

This dissertation analyzed the main reasons for the new and revised accounting standards issued by the BADC during the last two years. Throughout the 1990s, the bad loan crisis and a series of financial scandals and bankruptcies, caused in great part by

weak financial reporting and auditing practices, pressed the Japanese government to make fundamental reforms to the financial system, including corporate financial reporting regulation. The business and regulatory environment, such as the dominance of the MOF and the *keiretsu* and main bank business structure in existence for several decades, contributed considerably to the weaknesses in the accounting rules and the auditing system. Recent financial market innovations such as derivatives and the internationalization of financing and investing also played a role in impelling the BADC to make accounting improvements. In the end, the Japanese government started to make changes at about the last possible moment, only after great pressure from several sides. The international financial community considered Japanese financial reporting to be backward, with the Japanese government showing almost no signs of a desire to proactively address accounting issues until the BADC announced several significant changes in June 1997.

This dissertation also examined the effects of the recent accounting revisions. Although the new accounting rules resulted in many notable changes as discussed in the first paragraph of this section, the financial reporting regulatory structure and the business environment remain nearly unchanged. The fundamental financial reporting foundations and institutions established during the Allied Occupation, such as the triangular legal system and the MOF's predominant position, have changed little as a result of the Big Bang financial reforms. The current process of having the MOF dictate the issues agenda to the BADC does not allow for an independent, comprehensive, and proactive examination of accounting issues that will remain after implementation of the changes announced since 1997. Although the FSA since 1998 has taken over the MOF's previous responsibility for supervision and examination of financial institutions, the majority of the MOF's power, including regulation of corporate financial reporting requirements, remains firmly intact.

The BADC's announced accounting changes provide strong support to Prime Minister Hashimoto's call for 'free, fair, and global' financial markets, but the Japanese government has given other signs to indicate that its underlying attitude toward financial reporting has not changed. The temporary changes in accounting requirements for fiscal years 1997 and 1998 to allow companies to revalue land upward but not downward and to permit banks to use the cost method to value marketable securities may reflect the shallowness of the government's commitment to genuine changes to achieve transparent financial reporting.

The slow-paced implementation schedule for the accounting changes, such as the delay of pension accounting and fair-value accounting of cross-shareholdings until the fiscal year ending March 31, 2002, does not come close to the speed associated with a 'Big Bang' such as the one that occurred in the UK in 1986.

Despite the rhetoric from the Japanese government and BADC on the virtues of transparent, credible financial reporting, the attitudes of company leaders seem not to have changed much. The Keidanren's support for implementation delays and their opposition to some accounting revisions reflect the resistance of corporate management to major changes in financial reporting practices. The following statement from a managing director of a large industrial company illustrates the typical attitude of Japanese corporations: 'The existence of hidden profits has been criticized, but it can be of practical use for such things as maintaining employment. Managing without hidden profits will be a problem' (Kaneko 1999, 17). A survey of Japanese company leaders as to their opinions regarding the Accounting Big Bang would make an interesting study and would probably reveal widespread displeasure with at least some of the accounting revisions.

Few Japanese companies have realized the value of investor relations, where investors and analysts receive in a timely manner comprehensive and accurate company information beyond the minimum requirements set forth by laws and regulations. If company management actively and freely discloses relevant news, both good and bad, then investors and creditors begin to trust the company, which may lead to higher stock prices and a lower risk premium on borrowings. Good investor relations also may lessen the negative impact of bad news by eliminating or reducing unfounded speculation like what occurred in the international financial markets in the 1990s regarding the extent of Japan's bad loan crisis.

Even though the Japanese government has strengthened financial disclosure requirements, concerns remain as to whether or not disclosed information will begin to reflect the true financial situation of Japanese companies. Japanese financial reporting, despite the changes announced during the past two years, still requires improvements to fully realize the lofty goals of Prime Minister Hashimoto's financial system Big Bang and to completely satisfy the demands of investors and other stakeholders.

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