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Accounting and Disclosure in Japan

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1. Introduction

In this chapter I consider accounting and disclosure in Japan. I first explain the setting of the accounting standard in Japan, focusing on how this standard differs from international accounting standards and United States standards. I discuss to what extent the Japanese standard is original and how far it is approaching an international convergence following increased funding from overseas institutional investors.

Further, I focus on disclosure in Japan related to corporate governance, in particular, the disclosure of directors' remuneration and the audit fee. Since the legislation of the Sarbanes–Oxley Act in the United States, the volume of the brief earnings announcement of the most recent financial statement and Prospectus and Securities Report in Japan has rapidly expanded, and the contents of disclosure documents are gradually approaching similarity to those of Europe and the United States.

2. Difference Between Current International Accounting Standards and Japanese Accounting Standards

2.1 Accounting Standards in Japan

As regards accounting standards in Japan, the Commercial Code, Securities and Exchange Law, and the Opinion Book on Business Accounting Council have existed for a long time. The Commercial Code and Securities and Exchange Law are compulsory, and the accounting standards have been set by the Business Accounting Council under the control authority. All accounting rules have been set by public sector bodies.

However, to follow the organizational reform suggested by the International Accounting Standard Board (IASB), it would have to fulfill the condition that “accounting standard setting organizations should be private sectors that have a full-time staff,” were Japan to be influenced internationally concerning account-

ing standards. Thus, a private Financial Accounting Standard Foundation (FASF) was established, and the Accounting Standard Board of Japan (ASBJ) was set up within FASF. Some accounting standards have already been announced by the ASBJ. Setting of accounting standards by the private sector was introduced by way of the FASB (Financial Accounting Standard Board) in the United States, and due process has been introduced.

Accounting standards are therefore set in Japan by the Business Accounting Council, which is a public sector body, and the Accounting Standard Board of Japan, which is part of the private sector. However, Japanese accounting standards have some points that differ from international and United States standards, and it is for this reason that overseas investors might not correctly evaluate Japanese enterprises. Actually, it is thought that overseas standards are not necessarily correct from the standpoint of accounting theory, and Japanese original standards still exist although the difference between overseas accounting standards and Japanese ones has decreased. For example, accounting for business combinations has been clarified. Let us examine this point in more detail.

*2.2 Accounting for Business Combinations in Japan*¹

2.2.1 Distinction of a Company That is Acquired with an Acquiring Company

In the combination of enterprises, cash is delivered to buy the stocks from the stockholders of the company that is acquired, or stocks of the acquiring company are delivered. The former is a cash purchase and the latter is a stock transaction. Then, how can we judge the distinction between the company that is acquired and the acquiring company?

In Japan it is presumed that there are cases where we can distinguish the company that is acquired from the acquiring company or not in the combination of enterprises. Because a lot of business combinations seem to take place in order to control other enterprises under the management strategy, it should pertain that the distinction of the acquiring from acquired company is easily made. The United States accounting standards and international accounting standards also take this standpoint.²

However, the combination of enterprises comes about without a clear ruling as planned by “uniting the shares” in which the holding company is established by the transaction of the stocks, as with Mizuho Holdings. In that case, the economic substance comprises uniting the shares by the companies that participated. After they unite, they are assumed not to change. So we cannot distinguish the company that is acquired from the acquiring company.

¹ See Business Accounting Council (2003).

² See FASB (2001a) and IASB (2004).

In the case of establishing Mizuho Holdings, it was argued that the values of the stocks of three companies (Industrial Bank of Japan, Fuji Bank, and Daiichi Kangyo Bank) were the same because the ratio when the stocks were moved remained the same.³

However, in the case of establishing the holding company by moving stocks, sometimes we can distinguish the company that is acquired from the acquiring company. In 2001 Nippon Paper Industries Co. Ltd. and Daishowa Paper Mfg. established the holding company Nippon Unipac for the purpose of integration. In the combination, one stock of Nippon Unipac was exchanged for Nippon Paper Industries stocks 0.0010 and Daishowa Paper 0.0006 according to the ratio when the stocks were exchanged.⁴ The value of the stock of Nippon Paper Industries was higher than Daishowa Paper at the time. Therefore, it was judged that Nippon Paper Industries was an acquiring company.

Thus in distinguishing the acquiring company, the stock exchange ratio becomes the main element.

2.2.2 Pooling-of-Interest Method Versus Purchase Method

How does accounting treat what occurs? Here, I wish to focus on the method of evaluating the assets and liabilities.

If it is impossible to distinguish the company that is acquired from the acquiring company, the business combination is presumed to unite shares of the participating company, and all assets and liabilities are succeeded at the book value. Moreover, the retained earnings are succeeded as they are. This is called the “pooling-of-interest” method, which in fact was applied in the case of Mizuho.

On the other hand, if it is possible to distinguish the company that is acquired from the acquiring company, the assets and liabilities of the company that is acquired are evaluated at fair value, such as the market value, and the acquiring company writes this up in consolidation. This is called the purchase method. Here, it can be argued that economic substance after the integration changes because the assets and liabilities of the company that is acquired are evaluated at fair value. In the case of Nippon Unipac, the purchase method was applied.

In Japan, both of these accounting methods are permitted in business combination practice.⁵

2.2.3 Accounting for Business Combinations—FASB and IASB

In the past, in international and U.S. accounting standards, both the aforementioned purchase and pooling-of-interest methods were allowed only to some extent, and application of the latter method was permitted only under extremely

³ See the Prospectus and Securities Report of Mizuho.

⁴ See the Prospectus and Securities Report of Nippon Unipac. In 2004 Nippon Unipac changed its name to Nippon Paper Group, Inc.

⁵ See Business Accounting Council (2003).

limited conditions.⁶ This also applied in Japan. However, today only the purchase method is permissible in business combination through alteration of the accounting standards, and the pooling-of-interest method is prohibited in the U.S. and international accounting standards.⁷

Additionally, in the application of the purchase method, how the goodwill should be amortized differs between Japan and the United States.⁸ However, let us focus here on the application of the pooling-of-interest method.

2.2.4 Discussion on Pooling-of-Interest Method

When application of the pooling-of-interest method is permitted in Japan, the business combination in which it is impossible to distinguish the company that is acquired from the acquiring company assumes the economic substance to be unchanged before and after the business combination. Under the pooling-of-interest method the amortization cost is zero because evaluation of the succeeded assets is not done and goodwill is not generated. There is also an advantage that the retained earnings of the company that is acquired can be succeeded.

In the United States, on the other hand, gaining such an advantage using the pooling-of-interest method would be prohibited from a critical standpoint. It is argued that basically it is necessary to evaluate the assets succeeded by the business combination at fair value.

In the attempt to reach convergence of international accounting standards, the admission of the pooling-of-interest method in Japan remains a sticking point.

2.2.5 Response of Japan in Organizing Convergence of Global Standards

Japan explains the application of the pooling-of-interest method from the standpoint of accounting theory research.

Excluding the business combination, there are few points under discussion greatly different from international and U.S. accounting standards. Accounting for the impairment of assets taken up follows the United States standard,⁹ as does accounting for stock options.¹⁰

Regarding business combination and the admission of an original Japanese accounting standard, in short, the pooling-of-interest method has a negative effect on the securities market, because the business combination frequently involves international dealings and negotiation with overseas investors. In the United States and European countries, the accounting method for the business combinations that many investors demand is the purchase method, even if the pooling-of-interest method is permitted from a theoretical accounting standpoint.

⁶See APB (1970) and IASC (1998).

⁷See FASB (2001a) and IASB (2004).

⁸See FASB (2001b).

⁹See Business Accounting Council (2002).

¹⁰See ASBJ (2004).

Since the Sarbanes–Oxley Act in the United States was enacted, disclosure concerning corporate governance in Japan has been widened. The overseas securities market must be considered as important at the disclosure level, though it is not complete. Having described the situation in Japan concerning the original accounting standard on business combination, I now examine the current state of disclosure.

3. The Influence of the Sarbanes–Oxley Act on Japan

3.1 Disclosure Concerning Corporate Governance in the Brief Announcement of the Most Recent Financial Statement

In the brief announcement of the most recent financial statement following the end of the fiscal year submitted to the Tokyo Stock Exchange, the item concerning corporate governance was disclosed. This is called the “Basic idea concerning corporate governance and execution condition.”

The organization of management that is related to the mechanism of decision making in the company, the execution, and the supervision is reflected concretely in the figures. The distinction of whether there is a board committee system or an auditor system is stated. In addition, the election situation of external directors and external auditors, human relations, capital relations, the relations between dealings, and other interests are explained. Moreover, the mechanism of the operating audit, the accounting audit, and the internal audit is set out in detail.

The disclosure of the remuneration is divided into that of directors and auditors. Here, the total of the directors’ remuneration is shown, and the number of directors is disclosed. There is no distinction given here between external and internal directors.

3.2 Disclosure Concerning Corporate Governance in the Prospectus and Securities Report under the Japanese Securities and Exchange Law

Recently, new items have been obligated to be included in the Prospectus and Securities Report under the Japanese Securities and Exchange Law. The item concerning corporate governance is “Situation of the corporate governance.” Additionally, there are two items, “Risk of the business” and “Analysis of the financial position and the management result” relating to information concerning corporate governance.

These trends arise from the influence of the U.S. Sarbanes–Oxley Act that was legislated against the background of the scandal (including illegal accounting) of various enterprises and the Enron failure. In Japanese disclosure documents there now exists the heading “Situation of the corporate governance.” Let us examine this item in detail.

3.2.1 Board Committee System

“Situation of the corporate governance” in the Prospectus and Securities Report on a board committee system company is set out as follows.

Strengthening the supervisory function of management is explained as well as the brief announcement of the most recent financial statements. The supervision, the audit, the compensation decision, etc., are described. Managing boards of various committees (the nominating committee, the audit committee, and the remuneration committee) are explained in the figures.

It is argued that strengthening and enhancement of the internal management system will be achieved, to improve the influence of the audit by the audit committee in the explanation. This system ensures that monitoring by the audit committee is efficiently executed, and this is described as strengthening the corporate governance.

In addition, the in-house and outside directors are distinguished, and the separate classification of in-house and outside is used when disclosing the directors’ remuneration and the audit fee. Concretely, it is displayed as in-house directors, outside directors, and corporate executive officers. The remuneration of those who serve concurrently as director and corporate executive officer is disclosed in the section concerning the latter.

At present in Japan, the number of the directors and the total amount of the remuneration are disclosed in the classification of in-house and outside. This differs from the United States and some European countries where the directors’ remunerations are disclosed individually.¹¹

For the enterprises included in the overseas listing, especially in the United States, the membership of the audit committee must fill the independent directors’ requirement as based on the Sarbanes–Oxley Act.

On the other hand, fees, either from the audit or those other than the audit (for example tax consulting and M&A consulting are distinguished and disclosed among all payments to the accounting office, which now takes charge of the audit. In addition, the relation with the accounting office that takes charge of the audit is described in detail.

3.2.2 Auditor System

“Situation of the corporate governance” in the Prospectus and Securities Report of an auditor system adoption company contains the following.

A polite explanation is given about the situation of the approach to corporate governance. An explanation of the organization of management that is related to the decision-making, the execution, and the supervision within company management is given, even though it does not adopt the board committee system.

Especially similar to the board committee system is that while adopting the auditor system, some companies set up various committees to act as the advisory panel to the managing board. For instance, for Mitsui & Co., the governance com-

¹¹ See Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2004).

mittee, the nominating committee, and the remuneration committee are active. Moreover, because the board committee system is not adopted, these committee members are made up of both in-house and outside directors. However, for Mitsui & Co. the outside director also works as chairman of the remuneration committee.

An adequate description is made of the outside director's election, and whether he or she is independent is discussed though the auditor system is adopted. In particular, for Mitsui & Co. the internal management system was introduced after the legislation of the Sarbanes–Oxley Act in the United States. There are five committees (internal management committee, compliance committee, disclosure committee, crisis task force, and CSR promotion committee) that are related to business execution.

In the disclosure of remuneration, the outside and in-house directors are not distinguished, although the directors' remuneration and the auditor fee are reported separately. This is regarded as the main difference between the board committee system company and the audit system company. The total amount of remuneration and the number of directors are disclosed regardless of outside or in-house.

The audit fee is divided into those from auditing on business, on business related to the audit, tax consulting, and others (M&A consulting), much as in the board committee company. Additionally the relationship with the accounting office is specified.

3.3 Other Disclosure Items in the Prospectus and Securities Report

As mentioned above, it is “Risk of the business” and “Analysis of the financial position and the management result” that are new reporting obligations concerning corporate governance. These items explain the possibility of a bad influence being exerted on a business and of sufferance of any loss. Moreover, it can be argued that they explain the content written in the note to financial statements in detail.

The expansion of disclosure in the Prospectus and Securities Report is not paralleled by a change in the accounting standards. However, accounting information for investors is sure to increase and to influence the securities market. Additionally, by the enactment of the Sarbanes–Oxley Act, detailed disclosure is compulsory when listing in an overseas list, especially in the United States. The expansion of disclosure in the Prospectus and Securities Report in the securities market in Japan appears to be a positive trend toward introducing an idea similar to that in the United States.

4. Conclusion

In this chapter I have explained the setting of the accounting standards in Japan. Differences between the Japanese standards and those of the United States and

internationally were given special attention, because the difference in overseas accounting standards becomes a problem when funding in Japan is obtained from overseas investors.

The Japanese accounting for business combinations has permitted the pooling-of-interest method, although working toward international convergence is being done to reduce the differences in accounting standards in every country. It might be proposed that Japanese enterprises apply the purchase method in business combinations. In the United States the stockholders' proposal was included in the accounting for the stock option. There remains the difficulty of the coexistence of accounting theory and the idea of considering the stockholders' proposal as important.

In Japan, disclosure related to corporate governance is continuously required by the rules of listed companies of the Tokyo Stock Exchange and Securities and Exchange Law. I explained mainly the disclosure of management remuneration.

Management remuneration is disclosed individually in the United States and some countries in Europe, but not in Japan where, in the case of a board committee system company, the in-house and outside directors are distinguished in the disclosure of remuneration. The audit fees are divided into those from auditing on business, on business related to the audit, on taxation accounting, and others.

The investors request the individual disclosure of management remuneration, though Japanese companies have disclosed more accounting information in response to an overseas listing. In fact the stockholders' proposal to request individual disclosure of management remuneration was made to Sony, but was voted down.

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