GLOBALISATION AND THE ROLE OF FINANCIAL ACCOUNTING INFORMATION IN JAPAN

ISBN978 90 5170 776 2

Cover design: Crasborn Graphic Designers bno, Valkenburg a.d. Geul

This book is no. **399** of the Tinbergen Institute Research Series, established through cooperation between Thela Thesis and the Tinbergen Institute. A list of books which already appeared in the series can be found in the back.

Globalisation and the Role of Financial Accounting Information in Japan

Globalisatie en de Rol van Financial Accounting Informatie in Japan

Proefschrift

ter verkrijging van de graad van doctor aan de
Erasmus Universiteit Rotterdam
op gezag van de
rector magnificus

Prof.dr. S.W.J. Lamberts

en volgens besluit van het College voor Promoties.

De openbare verdediging zal plaatsvinden op

donderdag 1 maart 2007 om 13:30 uur

door

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geboren te Gouda

Promotiecommissie

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Acknowledgements

This project was initiated by Oscar Volder, who then chose a successful career in asset management. Professors Van Hoepen and Stam gave me the opportunity to start where Oscar left off, which was at the very beginning. They also introduced me to a world of knowledge, gave me wise counsel and support whenever I asked for it, and kept up the good faith even under the most adverse of circumstances. My deepest gratitude and respect go out to them.

The four years of research in Japan would have been very hard to realise if it had not been for the guidance and benevolence of Professor Kunio Ito of the faculty of commerce at Hitotsubashi University in Tokyo. My research in Japan was made possible by funding from the Japanese Ministry of Education and the Canon Foundation in Europe.

I am grateful for the friendship and support I received from the 3rd and 4th years, MA and PhD students of Professor Ito's financial accounting seminar 1998 to 2000. I believe that Ito-*zemi* represents the very best that Japanese universities have to offer. I also gratefully acknowledge the support of my boss Philip and my colleagues at the Science and Technology Office and other departments of the Royal Netherlands Embassy in Tokyo, which helped me make the right choice. Atsuko, Mihoko, and Momoko taught me to always look at the bright side of life.

I would like to thank my mother, grandmother, Irma and Bert for their unwavering support and encouragement. There is no way I can put into words what they mean to me so I won't even try. My friends Denise, Elizabeth, Marian and Monique have provided critical, stimulating, supportive and very necessary comments on all parts of life, which helped me to put things into perspective. Arjan deserves special mention as my *sempai* who saved the day and also has a contagious sense of humour. Last but not least there is Debin, my hero. Thank you for everything.

This book is dedicated to my father, because if he were still alive today he would probably read it from the first page to the last.

Carien van Mourik
London, January 2007

CONTENTS

LIST OF FIGURES

LIST OF TABLES

Chapter 1: Introduction

1.0. Globalisation and financial accounting in Japan

Globalisation has been made possible by ongoing development in transportation, communication and information technologies, and relies partly on the acceptance of global standards. Internationalisation is premised on the existence of nation states, and depends on effective national and international institutional infrastructure. Although trade over long distances is as old as the Silk Road, international trade took off between 1870 and 1920. After World War II international institutions such as the UN and the IMF were established and international direct investment increased substantially. In the 1980s international capital and financial markets boomed with the deregulation of financial markets. Global markets, like any market, are subject to market failure. Anti-competitive behaviour is a source of failure that the WTO, GATT and numerous bilateral and multilateral agreements and organisations attempt to right. Information asymmetry is another cause of failure. Financial statements are an important means of supplying useful and relevant information issued and audited in accordance with internationally accepted standards to minimise information asymmetry within and across borders.

The International Accounting Standards Committee (IASC) was established in 1973 by professional accounting organisations from nine countries [1] but has grown over the years. Initially the IASC opted for harmonisation rather than unification and issued basic standards. Partnership between the IASC and the International Organisation of Securities Commissions (IOSCO) resulted into a set of core standards since the mid-1990s. From April 2001 the IASC has been replaced by the International Accounting Standards Board (IASB) and its pronouncements go under the name of International Financial Reporting Standards (IFRS). Recently, the IASB seems to aim at global standards.

Internationalisation of business, financial and capital markets made comparability of financial accounting information across borders an important issue in the era of rapid growth after World War II, but even more so since the early 1980s when financial and capital markets started to overtake product markets in size. Managers of companies that are listed on overseas stock exchanges or issue bonds abroad must comply with the local accounting requirements either by issuing secondary financial statements or by issuing reconciliations according to local formats. Investors that venture into foreign

[1] The founding members came from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK and the USA.

stock and financial markets have to put considerable effort into understanding local financial statements. Local companies may obligingly issue financial statements that have been conveniently translated into English, restated into dollar or euro amounts, that partly follow US or international accounting standards, or that are complete secondary statements.[2] Accounting regulators find themselves faced with the political issue of balancing harmonisation of financial accounting and disclosure standards with the demands from local constituencies.

Both the Japanese Institute of Certified Public Accountants (JICPA) and the American Institute of Certified Public Accountants (AICPA) were involved in founding the IASC. Ironically, neither the US nor Japan have adopted the International Financial Reporting Standards (IFRS) issued by the IASB[3]. The US regards her standards as the highest and strictest in the world (Schroeder, Clark and Cathey, 2001, p. 191-192). Japan Business Federation considers IFRS unsuited to her particular business environment and complains that the IASB is not willing to listen to non-western proposals. Furthermore, the general opinion in Japan is that the recent overhaul of its accounting standards should suffice to make its standards comparable to IFRS (Japan Business Federation 2003).

This is important because in 2002 the EU announced that it requires companies listed in the EU to issue their financial statements in accordance with IFRS from January 2005. Foreign companies shall present their financial statements in accordance with IFRS or standards deemed equivalent as of January 1, 2007. In response the Study Group on the Internationalisation of Business Accounting of the Ministry of Economy, Trade and Industry (METI) issued a report advocating the acceptance of Japanese Generally Accepted Accounting Principles (JP-GAAP) as equivalent to IFRS in June 2004. According to the report, the scope of consolidation, tax effect accounting, accounting for financial instruments, accounting for impairment of assets, accounting for business associations, and accounting for R&D costs and intangible assets, are comparable to IFRS, but are in fact more conservative and therefore better comparable to US Generally Accepted Accounting Principles (US-GAAP) (METI Study Group on the Internationalisation of Business Accounting 2004). Convergence projects between the IASB and the FASB, and the IASB and the ASBJ are underway but will not produce the required results before January 2007.

In light of the claim of the METI report present study examines the extent of convergence between US-GAAP and JP-GAAP and analyses the role of internationalisation. Convergence implies the accounting and disclosure standards under the two systems moving toward each other. This study shows that in practice it meant the Japanese system taking on institutional characteristics and standards of the US financial accounting system and not the other way around.

A second issue that this study addresses is the motivation for voluntary

[2] Many international classification studies that used the English language version of financial statements by Japanese companies seem unaware of this fact and may therefore have overstated Japanese disclosure practices.

[3] The International Accounting Standards Board is the IASC's new name.

disclosure. Japanese companies that were already listed on the New York Stock Exchange before 1978, are allowed to issue their Japanese consolidated financial statements under the Japanese Securities and Exchange Law in accordance with US-GAAP.[4] These companies have been issuing their unconsolidated financial statements in accordance with JP-GAAP and their consolidated financial statements following US-GAAP. Until the Accounting Big Bang, consolidated disclosure under US-GAAP was much more extensive and of a higher quality than under JP-GAAP. Following US-GAAP amounted to practicing voluntary disclosure for Japanese companies. From the above arises the question: What motivated these Japanese companies to engage in the voluntary disclosure of audited financial accounting information? This study empirically investigates the relations between disclosure and the cost of capital, and between disclosure and corporate governance. Findings indicate that at least in the case of Japan, capital structure and corporate ownership seem to influence disclosure practices more strongly than cost of capital considerations.

1.1. Hypothesis development

International comparability of financial statements increases with the international convergence of financial accounting and disclosure standards. Accounting standards are set by the regulatory institutions of an accounting system. Regulatory and other institutions bear characteristics commensurate with a country's development pattern and phase. However, political, economic or social crisis sometimes brings about institutional change. In Japan such crises have resulted in abrupt or cumulative change in institutions and accounting regulations. The central hypothesis in this study is that the direction of such change depends on the function that financial accounting information performs. In a market economy financial reporting serves to minimise the transaction, information and monitoring costs related to information asymmetry. Therefore corporate governance and financial accounting standards fulfil complementary roles. Corporate governance supplies the accountability, incentive and monitoring mechanisms to minimise the cost of exchange for all parties to the nexus of contracts that constitutes a firm. Financial accounting standards provide the recognition, measurement and the minimum public disclosure of information to base the exchange on. In sum, in a market economy financial accounting is an indispensable and reliable means for public information disclosure. On the other hand, in a state-led economy private information exchange takes precedence over public information disclosure. Financial accounting then becomes primarily a means for taxation, policy implementation, and the calculation of distributable income. The function of accounting institutions and standards will oscillate between being a means for public information disclosure in order to address the problems of imperfect information on the one hand, and an instrument in policy implementation on the other.

Increased international comparability of financial statements is

[4] US-GAAP is still allowed for Japanese companies listed in the US but abolishment of this rule has been delayed several times already.

commonly regarded as beneficial to the users of financial statements. For some issuers of financial statements however, the costs outweigh the benefits. In product markets, the costs of disclosure are primarily associated with the proprietary nature of information (Healy and Palepu, 1993, p. 5). In other words, disclosing too much information is feared to harm a company's competitive position. Obviously, companies that do not sufficiently disclose risks, liabilities or losses hope to benefit from the adverse selection problem that lack of transparency poses to investors. Benefits to high disclosure levels come in the form of international investor confidence, and easier access to international capital and financial markets. Voluntary disclosure of accounting and other information at par with the highest internationally recognised standards is therefore practiced by companies that operate in international markets, raise capital at international markets, and practice accountability and transparency to accommodate their international investors.

The hypothesis with regard to the question why some Japanese companies choose high disclosure levels and others choose the legally required minimum disclosure levels is again based on the function of accounting information. Companies that depend primarily on direct financing (the market) show higher disclose levels than companies that depend on indirect financing (the main-bank system). Direct financing provides an important role for the public disclosure of accounting information in assessing risk and returns to investors in equity, bonds or other financial instruments. On the other hand indirect financing depends more on private information exchange between borrowers and lenders. In this case the role of accounting information is geared toward the protection of creditors and the calculation of distributable income. Hypotheses regarding a negative association between higher disclosure levels and lower cost of capital are premised on the role of financial accounting information in direct financing in a market economy. As mentioned above, this role is to mitigate the consequences of imperfect information by enabling better risk assessment and uncertainty reduction. This hypothesis may not hold in a period when most Japanese companies depend on indirect financing and the role of financial accounting is to determine income for distribution rather than as information to base investment decisions on.

1.2. Analytical framework

Crisis can bring about change in the institutional environment that provides what Williamson calls "the rules of the game" of economic organisation (Williamson, 1998, p. 27-28). Financial accounting and disclosure standards constitute "the rules of the game" with regard to information asymmetry. Present study identifies the crises that brought about institutional change in the Japanese accounting system inspired by Williamson's ideas on institutions and transaction cost economics. In Williamson's theory culture plays an important part in institutional change. Although this study acknowledges the validity of research on the influence that culture has on financial accounting standards with regard to measurement, recognition and disclosure (Gray, 1988), it builds on comparative studies of economic development (Gerschenkron, 1962), accounting

development patterns (Mueller, 1967; Nobes, 1983, Doupnik and Salter, 1993), institutions (La Porta *et al.*, 1997), and corporate governance (Ball, Kothari and Robin, 2000).

Relative economic backwardness provides a role for the state to replace functions of the market, especially financial and capital markets. In countries that were late to industrialise, generally code-law countries, companies depend more on indirect financing whereas in common-law countries enterprises make more use of capital and financial markets. Hence the function of financial accounting information in code-law countries focuses on the computation of distributable income and creditor protection, and may serve macro-economic policy purposes. Commensurate with the larger role of capital markets in common-law countries, the role of accounting and disclosure standards is to minimise the costs of problems related to asymmetric information.

Using the above dichotomy for the comparison between the Japanese and US accounting systems, this study builds a framework for analysing the extent of convergence. It is expected that a common-law country will have an accounting system that has private regulators and predominantly informal regulations. Such an accounting system focuses on information that is useful for investors and attaches higher importance to consolidated financial statements. In a code-law country the government (often the Ministry of Justice) establishes the accounting standards as legal requirements. These standards focus on the protection of and information needs of creditors, and attach primary importance to unconsolidated financial statements. In this way accounting institutions influence the accounting concepts and how accounting numbers are perceived. For example, are profits viewed as distributable earnings or as an indicator of corporate performance? To what extent is the distribution of dividends restricted? Is equity narrowly or broadly defined? Internationalisation comes with deregulation, which actually means a more market-oriented approach to regulation. As code-law countries progress on the path of internationalisation they adopt more institutional characteristics that hitherto were associated with common-law countries. New institutions establish new regulations which make convergence possible.

Internationalisation of markets eventually limits the extent to which a government can play a hands-on role in resource distribution and economic development. Instead a government then takes it upon itself to facilitate a level playing field for companies competing in the international arena. Internationalisation has induced deregulation and growth of financial and capital markets in Japan, and increased use of direct financing raised the demand for transparency and disclosure. Financial accounting and disclosure standards did not keep up with this demand because of institutional rigidity in the early 1990s. Therefore at the time there was ample room for voluntary disclosure.

In an overview of capital market research related to disclosure, Healy and Palepu (2001, p. 420) identified six forces that motivate or demote managers to engage in voluntary disclosure in a capital market context. These are capital market transactions, corporate control contests, stock compensation, litigation, proprietary costs, and management talent signalling. Presently, only capital market transactions and proprietary costs apply to the case of Japan. The

others could become relevant in studies that cover a period after the completion of the accounting big bang. Healy and Palepu (2001, p. 429) mention three types of capital market effects related to increased voluntary disclosure. These include improved stock liquidity, reduced cost of capital, and increased analyst following. Voluntary disclosure benefits the users of information by reducing information asymmetry and estimation risk. This in turn is expected to reduce uncertainty and lower the cost of capital, which is beneficial to the company.

Traditionally, institutional economics has centred on the legal institutions protecting property rights. Transaction cost economics, originally views the firm and the market as two alternative modes of production as a way to explain vertical integration and internationalisation of companies. Accounting institutions protect ownership rights by guaranteeing a minimum level of reliable and relevant information. Viewing the firm (debt) and the market (equity) as two alternative (Williamson, 1998, p. 32) and complementary modes of governance fits the idea that the firm is a nexus of contracts. When the firm is the mode of governance, private information exchange is used to keep transaction, information and agency costs low. In case the market is the mode of governance, transparency and public disclosure of information minimise transaction, information and agency costs. A transaction cost perspective to capital and ownership structures provides an important role for public information in mitigating the problems associated with information asymmetry that cannot be solved through private information exchange.

1.3. Purpose, perspective and importance of this study

In essence this study aims to draw attention to how internationalisation interacts with accounting institutions, financial accounting and disclosure standards, and corporate governance structures. Furthermore it provides a framework with which to analyse and predict accounting and disclosure standards and practices, based on the function of publicly available financial accounting information in the resource allocation process.

Japan’s case proves that as globalisation progresses truly international companies choose to follow international rather than local accounting standards. Benefits include better access to international financial and capital markets, and greater freedom from the imposing main-bank based block-holder type of corporate governance system. In this particular Japanese case, a higher weighted average cost of capital (WACC) indicates the price of freedom. Although convergence has increased, the WACC differential has not altogether disappeared. This indicates that the association between disclosure and corporate governance is stronger than between disclosure and cost of capital. It also means that the JP-GAAP group of large international companies still benefits from indirect financing and relationship investing. As such this study purports to contribute to the growing body of voluntary disclosure literature that seeks to find economic rationales motivating higher disclosure levels.

Although the fundamental orientation in this study is an accounting one, it sits comfortably in the field of business economics and borrows theory and methods from the economics and finance disciplines. In addition present

analysis makes use of studies in economic history and development, and cultural anthropology, to illustrate that international crises and national paradigms explain changes in environmental factors, accounting institutions and standards better than culture does.

This does not mean that I believe that globalisation eventually causes total convergence in the economic and political sense. States and markets perform complementary functions and therefore the tug of war in the areas where they overlap is likely to continue. However, unification of accounting and disclosure standards for participants in international financial and capital markets has its merits. International comparability of financial statements of multinational companies does facilitate better resource allocation decisions across borders.[5] In some countries adopting IFRS will lead to a dual structure with a national set of disclosure standards for small and medium sized companies and an international set of standards for large and multinational corporations. In other countries such a dual structure already exists because of the small number of large companies and the large number of SMEs.

The fundamental contribution of this study to the field of financial accounting is that it distinguishes between the roles that financial accounting information and standards perform under different modes of financing and different corporate governance systems. Analysing accounting and disclosure standards with regard to the functions they fulfil provides a useful framework for assessing financial reporting convergence. Applying this framework to the US and Japan, this study provides a comparison of the development and the financial accounting and disclosure standards of US-GAAP and JP-GAAP. It shows that convergence is progressing but not complete.

Furthermore, the comparatively long time-frame for this study into the association between the WACC and voluntary disclosure shows how the relation changes in nature and importance over time. Another important contribution is that this study investigates the relation between disclosure and the WACC whereas other studies analyse the associations between disclosure and the cost of equity or the cost of debt. In doing so present study shows that the cost and benefits of voluntary disclosure best be analysed with reference to institutional and corporate governance frameworks. The association between disclosure and corporate governance proves stronger and more stable, which indicates a certain reluctance or difficulty on the part of the companies in the JP-GAAP group to compete in global markets on international terms.

Finally, extensive use of Japanese language sources on Japanese accounting and the Japanese economy has provided this study with an angle and depth that would otherwise have been impossible to achieve.

1.4. Methodology and organisation

Part 1 of this study consists of Chapters 2 and 3 and is concerned with analysing the environmental and institutional changes to Japan's accounting system.

[5] In Japan, the JICPA even prescribes unified formats for financial statements and supporting schedules. From a user perspective this greatly simplifies searching for specific information and the comparison thereof.

Illustrating the progress, explaining the standards, and quantifying the extent of convergence between US-GAAP and consolidated JP-GAAP is the task set in Part 2 and carried out in Chapters 4 and 5. Chapter 6 constitutes Part 3 and seeks economic rationales for voluntary disclosure. A summary and conclusions follow in Chapter 7.

Chapters 2 and 3 present an analysis of the period 1868 to 2003. To structure the narrative this long period breaks down into four sub-periods as follows. The first period runs from 1868 to 1945, which forms the historical background for Japan's modern accounting system. Japan's accounting system came into being as a consequence of the Meiji Restoration and was part of a series of reforms to put Japan on equal footing with the West. After 1945 Japan's post-war accounting system developed into a means to support economic growth and increase investment and fixed capital formation in certain industries. This second period ended around 1980 after the introduction of consolidated financial statements, which signifies a reluctant step toward decision-usefulness of financial accounting information. The transition from accounting as a policy instrument to a financial accounting system that takes into account the needs of investors proceeded slowly from 1980 onward until in 1996 Prime Minister Hashimoto announced financial and administrative reform. Plans for Japan's new financial accounting system were announced in 1996 and implementation has taken place since 1998. The fourth period extends from 1996 to 2003.

Chapter 2 consists of a narrative discussing developments of each environmental factor in chronological order. It identifies the crises, institutions, policy objectives and paradigms that shaped the environmental factors of Japan's accounting system. Analysis of these environmental factors is based on predominantly historical and economic literature study using English and Japanese sources. Supporting data has been obtained from the Bank of Japan and Ministry of Finance downloadable statistics, and from the System of National Accounts through various sources. The role of accounting in the national paradigms and policy objectives, and the function of accounting standards and information as a tool for policy implementation indicate the direction in which the environmental factors and the Japanese financial accounting system itself developed.

Based on the changes in the functions of financial accounting standards and accounting information, Chapter 3 analyses Japan's financial accounting system with regard to the characteristics of the institutional framework from the viewpoint that accounting in Japan developed first as a macro-economic policy tool. Japanese accounting literature study provides the main source for analysis of Japan's accounting system's characteristics. Study of accounting theory literature and Japanese accounting theory literature forms the basis for the discussion of accounting concepts and approaches and how they in the past supported macro-economic policy objectives and are presently more oriented toward micro-economic development and supporting Japanese companies' competitive advantages.

Chapter 4 discusses convergence of accounting standards between US-GAAP and JP-GAAP using a similar approach and the same sources as in Chapter 3. Findings indicate that as the functions of accounting standards and

financial accounting information in Japan have grown more similar to those in the US, measurement and recognition standards have also become more similar.

Analysing the convergence of disclosure standards is the topic of Chapter 5. Detailed study of the disclosure standards under US-GAAP and JP-GAAP focused on the disclosure requirements in the notes and supporting schedules to the consolidated financial statements over a period from 1985 to 2003. Differences in disclosure standards are discussed in detail. Tables with references to accounting standards under US-GAAP, consolidated JP-GAAP and unconsolidated JP-GAAP indicate that disclosure requirements in Japan were definitely less than in the US but the gap has narrowed significantly since the year 2000.

In Chapter 6 statistical and regression analysis provide the means for exploring the associations between disclosure and cost of capital, and between disclosure and corporate governance characteristics. The period under analysis extends from 1985 to 2003, and was chosen because of limited availability in the years between 1978 and 1984. Data sources include the Nikkei Electronic Economic Data System (NEEDS), the Bank of Japan and Ministry of Finance downloadable statistics, and the CD-rom by the Japan Securities and Economic Research Centre. Data to estimate the disclosure levels of the sample companies are the product of the arduous labour of going through the 988 financial statements of all fifty-two companies in all 19 years at the Diet Library in Tokyo.

Chapter 7 will summarise and integrate the findings of all three parts of this dissertation. Recommendations for further research will be made based on the findings of this study.

Chapter 2: Environmental Factors and Paradigms

2.0. Introduction

There are many environmental factors that influence the development of an accounting system within a country. Mueller (1967) distinguished accounting development into a macro-economic and a micro-economic pattern. He then made a further distinction between accounting as an independent discipline where accountants made judgements and estimates, and accounting as a means for administration and control based on uniform accounting standards. Nobes (1983) further specified a law-based and an economics-based pattern of development. He found Japan hard to classify because the existence of the macro-uniform influence of the Tax Laws and the Commercial Code on the one hand and the micro-economic based influence of the Securities and Exchange Law inspired on the US versions on the other. His test of measurement practices placed Japan in the macro-uniform, continental, law-based group together with Germany. Doupnik and Salter (1993) then found that the accounting system development pattern dominated by macro-economic purposes and law-based uniform accounting standards was more prevalent in code-law countries. Accounting development spurred on by micro-economic purposes occurred generally in countries where accounting regulation by accounting professionals who left room for professional judgement and estimations. This pattern occurs in common-law countries, which also happen to have larger, more active and more developed capital markets.

Patterns of accounting development provide a clue to environmental factors and the way in which they influence a country's accounting system. Accounting system development is the subject of analysis in Chapter 3, but here in Chapter 2 the focus is on the role of environmental factors that influence accounting systems in general, and the Japanese accounting system in particular. Within the above framework, it is helpful to know that these studies classified Japan as a code-law country, and Japan's accounting system development as macro-economy oriented, with uniform accounting standards that serve the purpose of administration and control in order to implement administrative guidance with regard to macro-economic policies.

Radebaugh and Gray (1993, p.43-46) identified the following environmental factors; enterprise ownership, sources of finance, taxation, accounting profession development, political system, the nature and extent of economic growth and development, the legal system, inflation, culture,

accounting regulation, international factors, the social climate, and accounting education and research. Mueller, Gernon, and Meek (1994, p. 3-8) name the relationship between business and providers of capital, political and economic ties with other countries, the legal system, the level of inflation, the size and complexity of business enterprises, the sophistication of management and the financial community, and general levels of education.

Comparative research on the influence of international differences in the institutional environment, such as the legal regime or the government's participation in financial markets, on corporate transparency or on companies' capital structures has shown some affirmative results. Bushman, Piotroski, and Smith (2004, p. 244) find that the intensity and timeliness of financial disclosures increase when a country's government participation in its financial markets decreases. On the other hand, higher disclosure of governance related information occurs more in common law countries with high judicial efficiency.

La Porta *et al.* (1997, p. 1137-1138) found that "common law countries provide companies with better access to equity markets than civil law countries". Japan is classified as a German origin civil law country. Furthermore, stronger anti-director rights are found in common law countries, which also happen to have larger and broader equity markets. Ball, Kothari and Robin (2000, p. 47) study the influence of political influence on transparency of accounting information defined as the timeliness and conservatism of accounting income. Political influence is expressed as the dichotomy of the common-law shareholder governance model and the code-law stakeholder governance model. They find that conservatism and timeliness play a larger role in common-law countries, and continue to explain that this is caused by asymmetric conservatism (greater sensitivity to economic losses).

Culture as an explanatory factor seems to have lost favour with many in present day academia. For the influence of culture on accounting regulation and economic organisation one can refer to Hofstede's (1988) identification of four pairs of cultural values that affect behaviour in work situations. Gray's (Radebaugh and Gray, 1993, p. 67-76) translation into an identification of cultural values that affect the development of national accounting systems can be useful for a characterisation of corporate governance structures as well. Following is a brief discussion of Hofstede's (1988) cultural values. Scores are quoted from Perera (1989, p. 53, reproducing data from Hofstede, 1983).

Collectivism as opposed to individualism: collectivism is a value that could be found in large multinational companies that take care of their workers in providing them life-long employment, housing, education and a sense of belonging and security. *Keiretsu* are groups of companies that work together in order to support each other's activities and to reduce contracting costs. Essentially they are the post-war version of *zaibatsu*. Japan's score on individualism is 46 (rank 28-29) compared to that of the USA at 91 (rank 50 = highest).

Large power distance as opposed to small power distance: large power distance can be traced to Confucian influences that warrant a willingness to accept hierarchy and unevenly distributed power. The organisational structure of Japanese corporations is usually very hierarchical, and seniority still is an

important aspect. In the relations between companies there is usually a main bank or a main company who acts as a monitor and if necessary provides financial, management or technical assistance. Japan's score for power distance is 54 (rank 21) and that of the USA is 40 (rank 16).

Strong versus weak uncertainty avoidance: strong uncertainty avoidance may be found in the strict adherence to company rules and procedures such as job rotation within the firm and enterprise unions instead of trade unions. At the corporate governance level one can identify the interlocking of shares which served partly to prevent hostile take-overs. Japan scored 92 (rank 44) for uncertainty avoidance, whereas the USA scored 46 (rank 11).

Masculinity versus femininity: masculinity stands for achievement and material success, and femininity stands for relationships, modesty, and caring for the weak. According to Hofstede (1983, as reproduced in Perera, 1989, p. 53) Japan scored 95 (rank 50 = highest) on masculinity and the USA scored 62 (rank 36).[6]

Gray distinguished four pairs of culturally determined accounting values. These in turn are paired with relevance to authority and enforcement of accounting rules and to measurement and disclosure, according to which he classified the accounting systems in various countries.

Authority and enforcement can be classified by statutory control versus professionalism. These refer to regulation by the state through laws on the one hand and regulation by the accounting profession through self-imposed accounting standards on the other hand. The other classification of the regulatory system is along the concept of flexibility and uniformity of accounting standards (Radebaugh and Gray, 1993, p. 74-75). The Japanese regulatory system is characterised by a legalistic approach towards uniform accounting standards.

The pairs of "accounting" values with reference to measurement and disclosure are optimism versus conservatism with regard to measurement and recognition, and transparency versus secrecy with regard to disclosure practices. Gray classifies Japanese measurement practices as conservative, and Japanese disclosure practices as secretive. Chapter 3 of this study will discuss the characteristics of Japan's financial accounting system in detail.

A few last points about the influence of culture on the development of institutions need to be made. Informal institutions, customs, traditions, norms, and religion form a society's culture, and influence its institutional environment. Culture and cultural values are not static. Williamson (1998, p.26-27) postulates

[6] For what it is worth, based on my experience in Japan I would have expected Japan to score somewhat lower on individualism, much higher on power distance, and slightly lower on masculinity. Individualism is discouraged by Japan's society and has only recently come to be somewhat appreciated in companies. Hierarchy is very strong in Japanese companies. There is some consultation with lower levels in the hierarchy but superiors will rarely encounter contrarian opinions from people in a lower position. As for masculinity, although I agree that achievement and financial success are highly valued in Japan, I think that this score may not entirely do justice to the strength of the concepts of *on* and *giri* in Japanese society and companies. Both concepts are based on reciprocal obligations in hierarchical relationships where the higher and stronger party is obliged to help the weaker (*on*) and the weaker party is obliged to show his gratitude in return (*giri*).

that changes in culture may be spontaneous rather than calculative. Culture is often a source as well as an object of national pride. Therefore I think that changes in culture and institutions are calculative in response to shifts in national paradigms as will be discussed in Paragraph 2.6. National paradigms in the case of Japan were the response to international changes that were perceived as crisis events. Such a response needs a critical mass the time for which to build up probably corresponds to the urgency of the crisis.

As for influence of the political system, Japan is a constitutional monarchy. Until Japan's defeat in World War II, Japan was not a parliamentary democracy *pur sang*. Powerful elite bodies were the army, the navy, the bureaucracy, the Meiji oligarchs, the zaibatsu, and the Diet which consisted of a House of Peers and a House of Representatives (Reischauer and Craig, 1989, p. 224-225). After the depression from 1926 to 1931, the navy and army became stronger and stronger. After the war, the occupation authorities strived for democratisation. The Diet consists of the House of Representatives and the House of Councillors, whose members are elected. The Liberal Democratic Party (LDP) was continuously in power from 1955 until 1993, and has in one way or another been a government party since 1996. Although there has been ample internal strife by the various factions within the LDP, the survival of the LDP in government can be understood as a sign that both politicians and voters are striving for stability and continuity.

According to Beason and James (1999, p. 159) "Politicians have generally concerned themselves only with the broadest outline of policy issues, leaving the details to be filled in by the bureaucracy." Bureaucrats, especially of the Ministry of Finance and of the Ministry of Trade and Industry are said to have had frequent, formal and informal contacts with business and other constituencies. These contacts served on the one hand to obtain information on what the constituencies' interests were, and on the other hand to implement their own policies. Hence terms such as "Japan Inc." (Ishinomori 1992), "patterned pluralism" (Muramatsu and Kraus 1987), or "triad power" (Ohmae 1985) were used in the late 1980s and early 1990s. As we will see later, 1980 until 1996 is exactly the period where Japan's business community had considerable influence over accounting regulation.

MGM and R&G's lists of environmental factors are rather long but provide a starting point for the decision which environmental factors to analyse. We have already established that Japan's legal system is code-law based, and have briefly discussed Japan's political system, the code-law stakeholder governance model, and the political clout of the business community and their influence of culture on Japan's accounting system. Accounting regulation, education and research, as well as the development of the accounting profession are considered aspects of an accounting system in this study and shall be discussed in Chapter 3. The sophistication of management and the financial community as well as general levels of education are comparable to those in most advanced countries. Keeping in mind is that this study is conducted from the perspective of business economics, the remaining items listed by MGM and R&G can be succinctly summarised as follows.

(1) International relations

(2) Economic development
(3) Financial system
(4) Taxation system
(5) Corporate governance

This chapter presents a discussion of the above mentioned environmental factors and their impact on the Japanese accounting system. From the perspective of the accounting regulators in Japan, the reforms of the accounting system over time represent a response to the transition of the economic system based on political capitalism characterised by government control to an economy increasingly based on rational capitalism. Transparency and disclosure of reliable information enable rational investment decisions in the market place. Clearly, the stages in the development of the Japanese economy reflect the transition from a developmental economy to a mature economy. This transition has been caused and characterised by the internationalisation of business with politics in its wake, and by the globalisation of financial markets.

The developments within the sphere of each environmental factor will be discussed chronologically over the period from 1868 to 2003. A brief discussion of the pre-war period for each factor is in order to explain the origins and consequences of accounting development in Japan within a code-law and macro-economic policy oriented framework. Sections 2.1. to 2.5. will deal with the influence of international relations, economic growth and development, the financial system, the tax system and corporate governance practices respectively. Section 2.6. establishes the paradigms according to which the role of financial accounting information changed, after which Section 2.7. discusses the functions of accounting standards under different paradigms. Finally, Section 2.8. presents a summary and conclusions. Appendix I, Table A provides a reference framework for this chapter at a glance.

2.1. International relations

Political and economic events in the international arena sometimes provide stimuli for institutional change. These stimuli may take the form of an acute sense of national crisis or a more gradual awareness that current practices are no longer producing desirable outcomes. Accounting institutions and regulations will change along with national policies. Furthermore, internationalisation in the sense of the enormous increase of cross-border transactions and investment contributes to the development of standardised procedures, practices and information.

1868-1945

In Japan’s modern history we find one overriding concern that has influenced its political and economic development over the past one hundred fifty years. It is the concern of maintaining independence and sovereignty in the face of foreign threats or demands. From 1639 to 1854 Japan had been a closed country. Foreigners were not allowed to enter, and Japanese were not allowed to leave

the country.[7] As Reischauer and Craig (1989, p. 115) wrote, Japan was still free of serious external pressures in 1850. This changed when in July of 1853 a quarter of the US navy under the command of Commodore Perry reached Edo Bay and presented Japan with the demand to open up its ports for trade.
Confronted with this problem, the Tokugawa shogunate was unable to produce national consensus on how to deal with Perry's demands backed by an overwhelming military force. From then on until the present Japan has had to handle external pressures. Fear of occupation and colonisation motivated efforts toward modernisation in the last three decades of the 19th century.

The period of Japan's isolation that had started in 1639, officially ended when in 1854 Commodore Perry forced the Tokugawa Shogun to sign an unequal treaty with the USA. The treaty was unequal for it did not give the Japanese the right to set the tariff rates[8] on the goods that were traded by the Americans in the extraterritorial concessions in Japanese ports. Similar treaties were signed with the British, the Russians, the French and the Dutch.[9] The struggle to get rid of the unequal treaties lasted beyond the Meiji Restoration until the Tariff Act of 1897 abolished export duties, and "classified taxable imports into sixteen classes with rates varying from 5 percent to 40 percent" (Tsuru, 1995c, p. 45). Only in 1911 did Japan regain full tariff autonomy.

The period between 1853 and 1868 is known as the *bakumatsu*, or "end of the shogunate". Lack of consensus on how to respond to foreign pressure in 1853 was one of the main reasons for the eventual demise of the Tokugawa *bakufu*. In 1868 the shogunate was overthrown and the "de facto" rule of the Meiji emperor restored. The Meiji leaders were determined to prevent Japan from being colonised, and to make Japan a first class country that occupied a leading position in the world. The slogan "**prosperous country and strong military**" (*fukoku kyouhei*) indicated what their idea of a first class country was (Tsuru, 1995a, p. 16-17). This ideal was to be attained through industrialisation, using Japanese spirit and Western technology (Hoshi and Kashyap, 2001, p. 17-18).[10]

In pursuit of equality with the USA and European countries, Japan strove

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[7] Except for those tiny places where Dutch and Chinese were allowed to reside for the purpose of trade.

[8] The pre-Restoration agreement of 1867, which lasted until the Tariff Act of 1897 (effective from January 1, 1899), "applied a blanket 5 percent *ad valorem* rate on the value declared by importers at the place of origin. Extra-territoriality which went with the tariff agreement enabled foreign importers to stretch to the extreme its interpretation in their favor or even to smuggle with impunity." Tsuru, Shigeo (1995c), p. 45.

[9] Ishii *et al.*, (1998), p. 228-229. See also Ito (1992), p. 11, and Allen (1946), p. 20, for a description of the possibilities for arbitrage. These resulted in the outflow of gold, and inflation, because the Tokugawa government had fixed the exchange rate for silver to gold higher than the exchange rate at the world market.

[10] Morishima explains Japan's very economic success as having been caused by the Japanese spirit and Western technology. He states that the nature of Japan's Shinto religion is an ideology that provides "religious justification for the position of those in power and upholding the status quo" rather than " religion founded on the basis of individuals with the aim of helping humanity". "Since this areligiousness of the Japanese people led them to be materialistic, and since they were at the same time also nationalistic, they had no hesitation in working together for the material prosperity of Japan as a nation." Morishima (1982), p.196.

to modernise its society and economy. To that end, the Japanese leaders were to establish administrative unification of the country. In order to put down internal rebellion and to be able to defend Japan against foreign encroachment, the leaders stimulated technical development of military weapons. In the wake of the military industries followed heavy and mining industries, with the helping hand of the state (Tsuru, 1995b, p. 64; Allen, 1946, p. 73).

Regardless of Japan's previous apparent disinterest in foreign affairs, it started to involve itself in the affairs of other Asian countries. Through the war with China in 1894/95 and with Russia in 1904/05, Japan became a major colonial power in Asia. Among its foreign territories were Taiwan (Formosa at that time), Korea (since 1911), the southern part of Sakhalin, and Manchuria (since 1931). Thus it secured export markets and sources for the imports of natural resources. Japan took part in World War I on the side of the Allied Forces. As we will see later in section 2.2., World War I brought about economic growth and stimulated investment in Japan as well as in its overseas territories. The Pacific War gave Japan the opportunity to effectively occupy a large part of Asia, ranging from Indonesia, present day Singapore and Malaysia, up to Manchuria in Northern China. The wars with China and Russia had fuelled imperialistic and nationalistic tendencies that resulted in Japan's defeat in World War II, which in turn brought about the occupation that she had tried so hard to avoid in the preceding ninety years.

The prosperous country, strong army ideal can be understood as the purpose for which the nation and its institutions were being built, and for which wars were fought and colonialism started. Naturally, the development of accounting standards in that period served to enable that very same aim.

1945-1980

After Japan's defeat in the Second World War, the reforms under the Allied (American) Occupation Forces were aimed at democratising Japan. To this purpose the *zaibatsu* groups were dissolved, their shares sold to the public, and the Anti-Monopoly Act (promulgated on April 14, 1947 and fully implemented from July 20, 1947) was established. These measures dispersed economic power and increased demand for investment. The accounting regulations related to the dissolution of the *zaibatsu* had a great influence on the establishment of the Business Accounting Principles (BAP) in 1949 and on the improvement of the Japanese accounting system.

Redistribution of wealth due to land reforms started with the First Land Reform Act (promulgated on December 28, 1945 and operative from February 1, 1946). The emancipation of workers due to the Trade Union Law (promulgated on December 20, 1945, executed from March 1, 1946), the Labour Relations Adjustment Act of 1946, and the Labour Standards Law (promulgated on April 7, 1947 and executed from September 1, 1947) was another cause of democratisation (Chiba, 1998, p. 150; Ito, 1992, p. 54-55).

Russia, a member of the eleven-nation Far Eastern Commission prevented an agreement on war reparations because it insisted that plant and equipment removals from Manchuria and Sakhalin were war trophies instead of reparations. In April 1947, the USA used its power to instruct SCAP to carry out

the Advance Transfer Program, which allotted 30 percent of the industrial facilities declared surplus to Japan's needs to various East Asian countries (Cohen, 1949, p.421).

Imports of foodstuffs and industrial resources that were indispensable to maintaining the bare standard of living were largely financed by GARIOA funds (Government and Relief in Occupied Areas). Therefore the American taxpayer's interests may have contributed to the American government's policies favouring Japanese economic independence. "In 1947 and 1948 this aid amounted to US$404 million and US$461 million, equivalent to 77 percent and 68 percent of the c.i.f. value of the total Japanese commodity imports" (Allen, 1965, p. 51).

Upon surrender the Japanese economy came to a standstill, as there was no more purpose to 90 percent of the end-product output. Uncontrolled government spending during the war and the first six weeks after surrender on August 15, 1945 until the occupation authorities found out what was going on, had caused inflation. Initially, General Douglas MacArthur, who had been appointed the Supreme Commander of the Allied Forces (SCAP), only concentrated on democratisation and demilitarisation and left the responsibility for economic reconstruction in the hands of the Japanese people and government. After the Far Eastern Commission declared on January 23, 1947, that the standard of living should be restored to the level of the period 1930-1934, the responsibility to attain this goal rested with SCAP (Cohen, 1949, p. 417-419). The deterioration between the West and Russia, as well as the recognition that "China was unlikely to serve as a stabilising force in East Asia or an apt vehicle for American policy" (Allen, 1965, p. 17) caused SCAP to abandon its reformist zeal and concern itself with economic recovery.

The Korean War supplied the Americans with a strategic motivation for maintaining military bases in Japan. For Japan it meant substantial special procurement from the American army and an incentive to the manufacturing industry. Special procurement equalled about 30 percent of the value of imports in 1951, peaked at 40 percent in 1952, and declined to 12 percent in 1960 and to 5 percent in 1963. The value of imports rose from US$974 million in 1950 to US$1,995 million in 1951, to US$4,491 million in 1960 and US$6,736 million in 1963 (Allen, 1965, table 20 on p. 278). This was very important because due to the procurement dollars Japan could import more natural and industrial resources.

Signing the Peace Treaty of San Francisco in September 1951, and the Japanese-American Security Pact in May 1952, made Japan an independent country again. As soon as the Occupation Authorities left, the Japanese government started to rid itself of SCAP legacies that did not agree with their ideas of the road towards economic development. Rendering the Securities and Exchange Committee ineffective (Tachi, 1993, p. 190) with the amendment of the Securities and Exchange Law in 1952, and the 1953 revision of the Anti-Monopoly Law which authorised depression cartels and rationalisation cartels (Nakamura, 1981, p. 47) are examples of such measures.

As we will see in section 2.2., the Korean War greatly contributed to economic recovery. The end of the Korean War led to the beginning of the Cold War. Thus, after Japan gained independence, the American government

continued to have military bases in Okinawa.[11] Art. 9 of the Japanese Constitution renounces Japan's right to wage war. This is why, officially, Japan has self-defence forces instead of an army. The American military presence, which was a consequence of the Japanese-American Security Pact, exemplifies Japan's dependence on the USA. However, GARIOA aid stopped in 1953, and US procurement spending declined after the Korean War.

Until 1971 everything seemed to go smoothly. The Japanese were concentrating on economic growth, using all the available means. In the meantime Japan reached agreements on war reparations, and re-established diplomatic and trading relations with countries of its former so-called "Greater East Asia Co-prosperity Sphere" in the mid 1950s. Credits, loans, aid and investment soon followed (Reischauer and Craig, 1989, p. 316). Furthermore, Japan entered the International Monetary Fund (IMF) and the Bretton-Woods system of fixed exchange rates in August 1952. For a country aiming to be a trading nation, admittance into the General Agreement of Trade and Tariffs (GATT) was of the utmost importance. After initial resistance from Great Britain, Japan was allowed to enter the GATT in August 1955 under pressure from the USA, and became a member of the UN after normalisation of relations with the Soviet Union in 1956. By the mid-1960s, Japan had become the leading economic power in Southeast Asia.

In 1964, Tokyo hosted the Olympic Games. This was an opportunity to show Japan's economic progress to the rest of the world. Normalisation of relations with South-Korea followed in 1965. Relations with the People's Republic of China were impossible because, under US pressure, Japan had recognised Taiwan in 1952. The announcement in July 1971 that US President Nixon would visit China in 1972, was called the "Nixon Shock" because it came without any prior notification, and added to a sense of insecurity. Nevertheless, it started a series of agreements leading to a peace treaty in 1978. The Japanese sense of insecurity was even strengthened when in August 1971 President Nixon unilaterally ended the Bretton-Woods system by terminating the convertibility of USD35 into 1 oz of gold. This "Dollar Shock" was followed by the "Oil Shock", starting in October 1973, when the OPEC countries announced an oil embargo. With this turn of events, the post-war era that had been characterised by high economic growth ended.

By 1975 the Japanese economy was the third largest in the world after that of the US and the USSR. The First Oil Crisis had left Japan feeling very vulnerable to external supply shocks, and induced a national sense of crisis resulting in economic restructuring. The oil shock also marked Japan's first departure from compliance with US foreign policies. In order to secure access to the oil its economy was so dependent on, Japan engaged in resource diplomacy. This kind of diplomacy took the shape of loans, technical co-operation, and financing of oil refineries (Hook *et al*., 2001, p. 32 and 96).

In sum, after the occupation forces left, rebuilding Japan, **making the country and its people prosperous**, became the overriding national goal. This

[11] Okinawa was returned to Japanese administration in 1972, but only in 2005 did the US consider to leave their bases in Okinawa in order to redeploy their troops elsewhere because of the aftermath of the War in Iraq.

goal was exemplified by the Yoshida doctrine that gave primacy to economic growth (1948-1954) and “The Income Doubling Plan” (1960-1964) of the Ikeda Cabinet.[12] Accounting standards served the purpose of promoting capital investment, retaining funds within companies for reinvestment, and directing scarce resources according to economic policy priorities. Economic power gave the Japanese a source of national pride and leverage in the international arena.

1980-1996

The US had been Japan’s most important trading partner as well as its closest ally. Having taken the favourable trading terms for granted, Japan encountered increasing allegations of protectionism and dumping as the Japanese trade surplus increased. Especially in the 1980s anti-Japanese sentiments grew stronger as trade imbalances grew larger. Trade negotiations concerning textiles and steel had been conducted in the 1960s and 1970s. Machine tools and automobiles were the subjects of negotiations in the late 1970s and early 1980s. Negotiations resulted in voluntary export restraints effectively limiting the yearly number of automobile exports to the US. The Ministry of International Trade and Industry allotted export quota to the car companies (Ito, 1992, p. 370-371).

An unanticipated consequence of the two oil shocks was an emerging awareness that the status of large economic power also includes political responsibilities towards the international community. Until then, Japan had been getting by under the wings of US international policies, but that policy proved increasingly unacceptable. Japanese style overseas development assistance(ODA)[13] and foreign direct investment (FDI) in Asian countries consolidated Japan’s role in the region. ODA and FDI to East Asia often served the strategic and political purposes of market penetration and creating interdependent relationships. To a certain extent, the Japanese experience became a model and a source of inspiration for economic development in various newly industrialising Asian countries.

Trade conflicts extended to political conflicts where the US considered Japan an unfair trading partner violating trade agreements, closing its home market, and practising dumping in order to destroy other countries’ industries. In turn Japan considered the US a bully as well as a cry-baby in need of critical self-examination in order to improve the productivity of its industries and the quality of its products.

Trade frictions with the US and European countries culminated in the Structural Impediments Initiatives starting in the autumn of 1989. The talks resulted in a report in May 1990. The conclusions were that Japan should solve the following structural problems: “saving and investment patterns, land policy, the distribution system, exclusionary business practices, keiretsu relationships, and pricing mechanisms.” In turn, Japan pointed out what it saw as problems on

[12] Reischauer and Craig (1989), p. 285, 286, 288 (regarding Yoshida) and 310 (regarding Ikeda).

[13] Overseas development assistance centred largely around exploiting the natural resources of East Asian countries, tying development assistance to the purchase of Japanese goods and services (explicitly until about 1980, or implicitly), which helped Japanese companies gain access to East Asian markets. See also: Hook, et all (2001), p. 194-196. For another reference see Research Committee into the Determinants of Foreign Policy (1999), p. 352.

the US side including “a lack of saving, a lack of worker training, and a deficient educational system” (Ito, 1992, p. 376-377). Segmental disclosure (since 1994) and related party disclosure requirements (since 1992) are a result of the Structural Impediments Initiatives.

At the US-Japan summit in November 1983, a bilateral project team, “the Yen-Dollar Committee”, had been established in order to investigate the need for Japanese financial reform. The result was the Yen-Dollar Agreement in May 1984, pointing out areas for deregulation in Japan’s financial system. September 1985 saw the Plaza Accord, which called for intervention to bring about the appreciation of foreign currencies against the dollar so as to have the exchange rates better reflect underlying economic conditions (Malcom, 2001, p. 88-89). The Louvre Accord of February 1987 was meant to stop the fall of the US dollar, but it was unsuccessful at putting an end to the rapid appreciation of the Japanese yen (Hoshi and Kashyap (2001, p. 226). It can be argued that the currency interventions combined with very loose monetary policy allowed the asset-inflated bubble economy to grow, until the bubble was finally burst due to a rise in interest rates.

Changes in the communist countries starting with Gorbachev’s perestroika policies from 1985, and the fall of the Berlin wall in 1989, brought about renewed diplomatic relations between the USSR and South Korea, and China and South Korea. The Tienanmen Square Incident of June 1989 led the US and European states to impose sanctions. Although Japan did not oppose these sanctions, it did not criticise China as much as the other G7 countries did. This was possibly partly out of guilt over its own past actions in China such as the Nanking Massacre. Instead Japan tried to avoid international isolation of China. To the purport of which, Japan reverted to unofficial diplomacy (Hook *et al*., 2001, p.169-170). Part of which took place through private business relations, which makes one suspect that the attractions of the large Chinese market were another motivating factor. China’s open door policy and the apparent defeat of communism created new opportunities and markets.

The year 1990 and 1991 saw the Gulf War giving the Kaifu and Miyazawa cabinets trouble deciding on their stance and on the actual contribution that Japan could make to support the peace keeping operations without violating Article 9 of the Constitution (Ishii *et al*., 1998, p. 360).

After the burst of the bubble economy, competitive positions of Japanese financial institutions deteriorated gradually, although it still took the better part of the decade to find out how bad their situation actually was. However, the Clinton administration in the US took new initiatives for bilateral negotiations to open up Japan’s markets for automobiles, insurance and fund management between 1993 and 1995. GATT’s Uruguay Round took place around the same time and ended on April 15, 1994. The yen remained relatively stable although strong against the US dollar at between 90-100yen per US dollar.

Scandals related to payments by securities companies for compensation of losses sustained by privileged clients surfaced in 1989. These payments had been prohibited by law in October 1991, but that did not deter the companies from continuing these payments. New cases came to light in 1997 (Malcom, 2001, p. 88-89). The international financial community watched several credit

co-operatives fail one after the other, and saw the capital erosion of Japanese banks due to the fall in stock and real estate prices. Allowing the failure of the Hyogo Bank in August 1995 meant the end of the “convoy system”. As a consequence of this change in attitude of the Japanese government, internationally active banks perceived loans to Japanese banks as increasingly risky, and therefore demanded a “Japan premium” on inter-bank loans to Japanese banks (Peek and Rosengren, 2001, p. 286).

In the early 1980s, when 80 to 90 percent of the Japanese population considered themselves to be prosperous and middle-class (Ishii *et al*., 1998, p. 360) it had become much harder to motivate everybody to work in a concerted effort to achieve economic growth. Social security issues, deregulation in response to internationalisation of business, fiscal deficits, trade frictions, and a changing world caused a lack in clarity of purpose, and made it **impossible to identify and raise support for a single national goal**. Furthermore, the old administrative and financial institutions that had served the paradigm of economic growth so well in the past turned out perverted and rigid in their approach to new circumstances. In the area of accounting standards we could see a piecemeal approach to unification of the system and the adoption of new standards for new financial products.

1996-2003

To make matters worse, the Asian financial crisis of 1997 affected Japan seriously. Japan conducted a larger part of its trade with Asian countries than did other G-7 countries. In 1998, the World Bank estimated that “loans to Asian-crisis countries account for 43 percent of the capital of Japanese banks (versus 27 percent for the G-7 countries as a group)” (Goldstein, 1998, p. 21).

In 1999 the Diet passed a revision to the Self Defence Law so Japan could take part in the peace keeping operations in Kosovo. Art. 9 of the Constitution is more and more a topic of discussion. Although officially Japan does not have an army, its self-defence force is large and well-equipped and has the world’s fourth largest budget.

The heavily debated *Kimigayo* and the *Hinomaru* became the national anthem and the national flag on September 9, 1999, and may be understood as a sign that for a part of the population nationalist sentiments are not a thing of the past. However, the terrorist attacks of September 11, 2001 on US targets, and the ensuing war in Afghanistan again raised pressure on Japan to contribute to international security in a military way. This resulted in Japanese SDF staff going to Iraq in 2003 in order to assist reconstruction efforts.

Japan’s government bonds have been downgraded several times by various rating institutions between 1998 and 2002. Although Japan’s national debt was already sky-high, the government planned to issue even more debt and also use public money to stabilise the bad loans situation in its banking system. It seems that the financial system has indeed stabilised and there is even room for cautious optimism about economic growth over 2005. In order to raise capital in the EU Japanese companies are required as of 2007 to issue their financial statements in accordance with IFRS or equivalent reporting standards. Presently, there is a project underway to study the remaining

differences between IFRS and JP-GAAP and investigate if further convergence is necessary.

In response to the near collapse of the financial system due to an exacerbation of the bad loan problem towards the end of the first half of the 1990s the government could no longer avoid taking action (see section 2.6.). Prime Minister Hashimoto announced a plan in 1996 “with the aim of revitalizing the Japanese financial market commensurate with the international markets of New York and London.”[14] In its wake followed a huge overhaul of the financial accounting system. Both the financial system and the accounting system seem to be designed to at the very least **create a level playing field for Japanese companies at international capital and financial markets**.[15] The functions of the accounting standards in this respect are providing transparency, and timely and full disclosure in accordance with international standards.

2.2. Economic growth and development

Like technological development, accounting has been an indispensable ingredient for industrialisation. Technology raised factor productivity, and financial accounting contributed to the development of joint stock corporations, capital markets and a more efficient distribution of scarce resources. GNP growth is an indicator of a country’s economic growth and activity. Interest rates provide a first indicator of the cost of funds and investment. Without barriers to international capital mobility, there is a relation between interest rates, exchange rates and rates of Inflation. Exchange rates are important for exports and imports, and provide accountants with the challenge of foreign currency translation. Inflation affects price levels, wage levels and thus the cost of raw materials and labour in productivity, but provides accountants with the challenge of accounting for the cost of inventory, work-in-process, and the cost of goods sold.

Economic growth through industrialisation would not be possible without investment in productive capacity. Therefore, the final item that this paragraph touches on is capital formation. For an overview of long-term economic indicators see Appendix I: Table B.

1868-1945

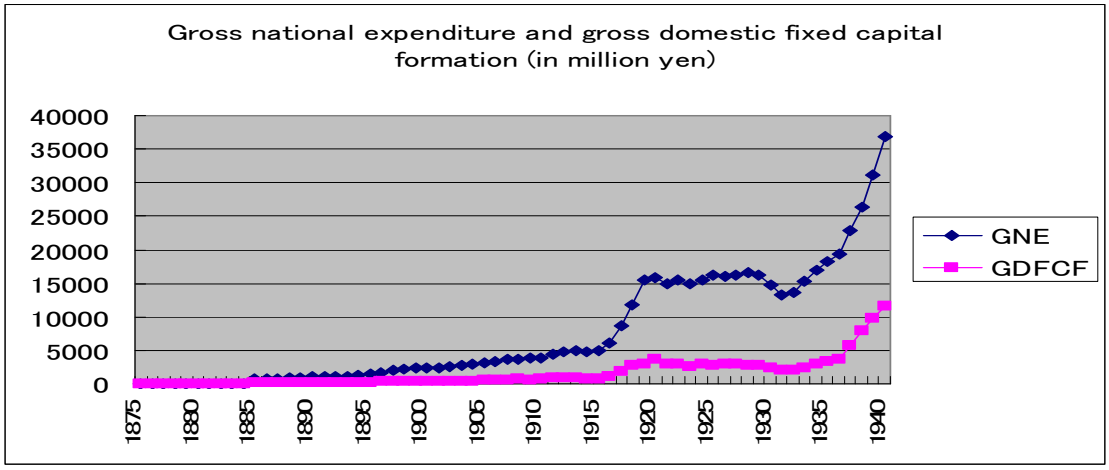
Industrialisation in Japan started in earnest in the mid-1880s (Minami, 1994, p. 84). Inflation had been a huge problem in the late 1870s but was brought under control by Finance Minister Matsukata in the early 1880s. The government started up businesses in strategic heavy industries that were soon sold cheaply to private entrepreneurs, many of whom benefited from this relationship. Figure 1, which is based on Appendix I, Table B shows clearly that growth in Gross National Expenditure as well as in Gross Domestic Fixed Capital Formation were ignited by the Sino-Japanese War (1894/95), the Russo-Japanese War

[14] http://www.mof.go.jp/english/big-bang/ebb1.htm

[15] Porter, Michael E. (1990), *The Competitive Advantage of Nations*, USA, New York, The Free Press, may have had significant impact on the ideas regarding the regulatory functions of the Japanese state. Instead of trying to create national comparative advantages, the Japanese government is now trying to facilitate companies to build up competitive advantage.

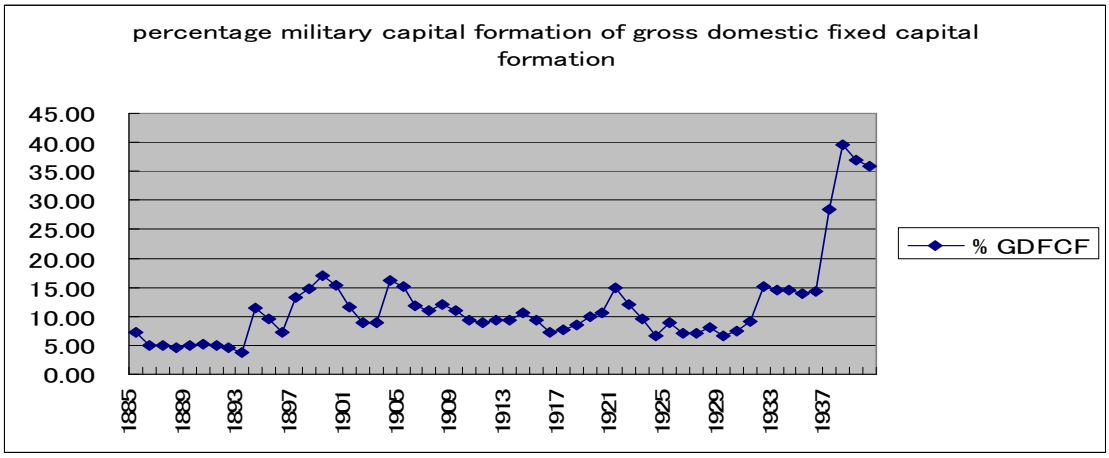
(1904/05), and particularly World War I (1914/18) contributed to upswings in economic growth.

Figure 1: GNE and Gross Domestic Fixed Capital Formation (1875-1940)



Looking at Appendix I, Table C, we find that the largest percentages in growth of military capital formation were in 1894 and 1897 (317 and 141 percent respectively), 1917 and 1918 (85 and 64 percent), 1932, 1937 and 1938 (75, 210 and 96 percent respectively). In 1938 military capital formation constituted 39.6 percent of total Gross Domestic Fixed Capital Formation (See also Figure 2).[16] Appendix I, Table B further indicates that an enormous increase in exports caused a considerable trade surplus between 1915 and 1919. Hitherto and thereafter until the 1960s the trade balance showed predominantly negative figures.

Figure 2: Military capital formation percentage of Gross Domestic Fixed Capital Formation



Depression started in 1927 in Japan and was exacerbated by the world depression in 1929. Keynesian policies by Finance Minister Takahashi Korekiyo

[16] Estimations based on Ohkawa, Shinohara, with Meissner (eds.) (1979), Table A1 on p. 251-260 as reprinted from LTES 1:213 (table 18), and Table A5 on p. 261-263, as reprinted from LTES 1:190 (table 6).

induced an upswing, starting with the abandonment of the gold standard in December 1931. The war economy started from 1937 and made the munitions industry priority number one for which purpose special taxations measures and accounting rules were established. (See paragraph 2.4.) The national accounts for the World War II period may not be so reliable. However, for the period 1935 until 1946, Flath (2000, p. 89, table 4.1.) states an average annual real GNP growth rate of –4.89, based on Economic Planning Agency data.

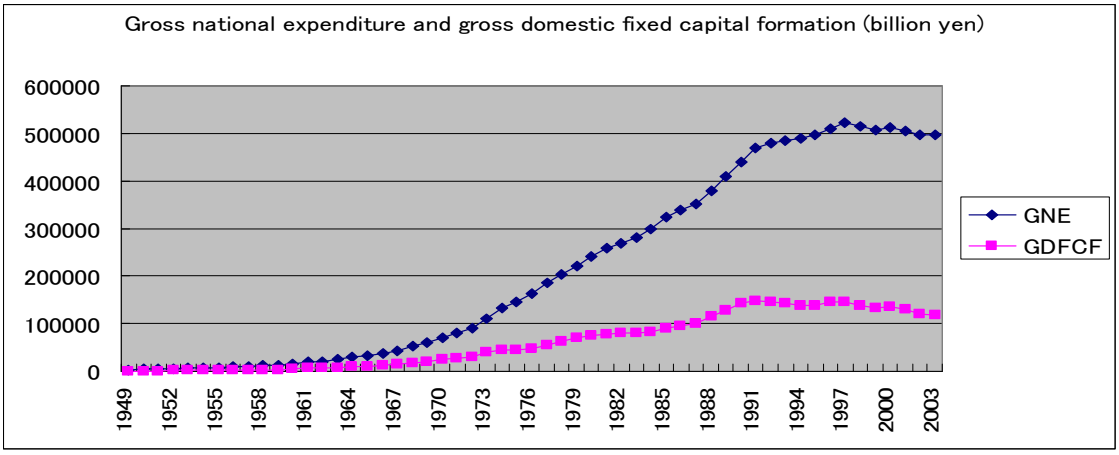
1945-1980

It is difficult to evaluate Japan's economic policy between 1946 and 1948. The government was trying to accelerate the recovery of productive capacity in major industries on the one hand, whilst trying to tame rampant inflation on the other. Appendix I, Table B shows that the price index with base level 1934-1936 rose from 3.5 in 1945 to 342.5 in 1951. Attempting the former took place through expansionary fiscal and monetary policies, for which the Reconstruction Finance Bank was the main vehicle (Ito, 1992, p. 58). See paragraph 2.3 and 2.4. for further discussion. Attempting the latter took the form of dissolving all private claims against the Japanese government arising from wartime procurement etc., and freezing assets and imposing a graduated tax ranging from 10 percent to 90 percent on personal assets exceeding JPY100.000 (about USD15.000 in 1995 prices) (Flath, 2000, p. 81).

From 1950 until 1970 rapid economic growth prevailed in most developed countries. In the 1950s the growth rate in Japan was around 8 percent, and in the 1960s it was around 11 percent. Economic growth, when defined as growth in GNP, is growth in aggregate demand. Aggregate demand is made up of the sum of consumption, investment, government expenditures, and net exports (exports – imports). Following the source approach to analysing economic growth, one looks at output (aggregate supply). Output should be equal to aggregate demand in the long run. The factors of production are capital, labour (working hours and employment), and technological level.

When comparing the contributions of labour, capital and technological progress to the growth rates of GNP, Ito found that over the period between 1953 and 1971, the production factor labour contributed 21 percent, capital contributed 23.8 percent, and technological progress contributed 55.2 percent. Knowledge in the form of technology transfers from Western countries, and scale economies constituting the lion’s share of technological progress. For this period, capital accumulation contributed more than labour. However, for the period from 1970 to 1980, the contributions for labour, capital and technology were 20.9 percent, 19.8 percent, and 52.5 percent respectively. Increases in employment and education accounted for the growing contribution from the labour factor. On the other hand, the “hours” component of labour input decreased from 2.4 percent for the first period to –5.3 percent for the second period. Thus indicates that the abundance of cheap labour of the 1950s and 1960s had come to an end (Ito, 1992, p. 48-50). In the early 1970s the industrial structure had shifted from enormous capital investment in heavy industries to more knowledge intensive industries. The first oil shock accelerated this process significantly.

Figure 3: GNE and Gross Domestic Fixed Capital Formation (1949-2003)



Since 1973 the increase in Gross Domestic Fixed Capital Formation did not keep up with the increase in Gross National Expenditure (see Figure 3), which indicates that the importance of other input factors such as technology increased more quickly.

Looking at aggregate demand, it is important to note that due to scarce foreign currency reserves and strict capital controls until about 1964, the possibility for net export growth was dependent on earning enough foreign currency to pay for imports of natural resources. Exports increased from 5 to 11 percent of real GNP between 1955 and 1974. Furthermore, gross investment as a percentage of real GNP steadily increased from 16 percent in 1955 to 39 percent in 1973. Inflation remained fairly stable at around 5 or 6 percent, except during the oil shock (Teranishi, 1999, p. 129, table A).

The first oil crisis hit Japan very hard. In 1974 it resulted in negative economic growth (-1.4 percent), high inflation (GNP deflator 12.9 percent in 1973 and 20.8 percent in 1974), and declining investment. Exports as a percentage of GNP halted briefly, and the increase in money supply was considerable. The effects of the second oil shock were not nearly as conspicuous, and the economy continued to grow albeit at slower rates than before. Soon after the second oil crisis the growth in exports recovered again (Teranishi, 1999, p. 129. table A).

1980-1996

It is likely that the somewhat slower growth in exports owed to the appreciation of the yen against the dollar after the Plaza Accord in 1985 (See Appendix II, Table A). Money supply growth of about 10 percent per annum between 1985 and 1990 is one side of the loose monetary policy that caused the asset-inflated bubble economy. The other side is the official discount rate remaining at 2.5 percent throughout the whole period (Ito, 1992, p. 133). See Appendix I, Graph A for changes in the discount rate.

The asset inflated bubble economy got punctured when the discount rate was raised in several steps from 2.5 percent in May 1989 to 6 percent in August 1990. Stock prices plunged first, and real estate prices started to fall

dramatically in 1992. The *Heisei*-recession was a fact.[17] Since 1995 deflation has been threatening the economy and has aggravated the bad loan problem. A strong yen has reduced the attractiveness of Japanese products. Therefore the share of exports in economic growth has remained somewhat lower than before the burst of the bubble. Investment in plant and equipment seems timid as a consequence of previous over-investment in production capacity and present low utilisation rates. Adding to this are the difficulty in raising capital at the depressed financial and capital markets and the fact that monetary growth is much lower than it was during the bubble years.

1996-2003

The bad loan problem and the deflationary pressure are destabilising the financial system and are severely damaging the economy as a whole. Japan's national debt is currently hovering at about 160 percent of her GDP, and her bond ratings have been lowered from 2002. Japan's Bond Dependency Ratio in 2003 was 44.5 percent, compared to 27.6 percent in 1996.[18] The official discount rate was lowered to 0.5 percent in 1995 and stayed there until January 2001, after which it was lowered to 0.35, 0.25 and finally to 0.1 percent where it has stayed since September 2001.

Japan was not alone in experiencing economic hardship, especially after the terrorist attacks on September 11, 2001 it became clear that the economies of the US and many European countries had also stopped flourishing. The Enron debacle and some other scandals turned the international public attention to the questionable quality of US accounting and auditing standards. Most stock market indices show a downward trend. After the completion of the Japanese Accounting Big Bang in 2001, revision of accounting and auditing standards is likely to continue as an ongoing process. An important task is to restore investor confidence in the market as well as the quality of financial and other information.

2.3. The financial system

A country's financial system provides the infrastructure for the distribution of resources. Fund and capital distribution may depend on the market mechanism or may be subject to strict financial controls. Companies gain access to funds directly at capital or financial markets, or indirectly through bank loans. Countries with well-developed free financial and capital markets usually try to sort out information asymmetry problems through extensive accounting and disclosure standards. On the other hand, countries where companies depend more on bank lending provide a larger role for private information exchange and are likely to be less concerned with presenting a fair and true view of a company's value and performance than with creditor protection.

[17] The first year of the *Heisei* period was 1989, and we are presently (2006) in the 18th year of *Heisei* and the recession is not over yet.

[18] http://www.mof.go.jp/english/budget/brief/2004/2004f_01.htm, (April 4, 2006).

1868-1945

Intending to realise its “rich country, strong army” ideals, the Japanese government planned the growth of a private banking sector through the establishment of national banks. In 1869 the government established the Ministry of Finance (MOF). In 1872, the MOF promulgated Japan’s National Banking Act. And the following year the First National Bank was founded (Ito, 1992, p. 31). The First National Bank was also the first joint stock corporation, as well as the first corporation to which accounting provisions applied. Many banks quickly followed. By 1880, about 32 percent of the total sum of national bank capital of JPY42.1 million belonged to the ex-samurai. In turn, 96 percent of this share was concentrated in the Fifteenth National Bank of Tokyo. Except for this “Nobles Bank”, merchants increasingly became the main proprietors in the national banks. The Mitsui Bank opened its doors in 1876 and was the first Western-style merchant bank in Japan (Tamaki, 1995, p. 38-41).

In 1878 the Tokyo Stock Exchange opened. Initially most of the transactions concerned specie and public bonds, but already in the 1890s the larger part consisted of trading stocks. Although at the bourse, the transactions were mainly margin transactions of a speculative nature in leading stocks such as railways and spinning. Spot transactions in stocks were actually conducted over-the-counter in the area around the stock exchanges in Tokyo and Osaka (Shimada, 2004, p. 34-35).

Finance Minister Matsukata, who had been appointed in October 1881, addressed the inflation by policies intended to balance the budget and increase the amount of silver and gold specie. The first step was to abolish inconvertible government notes. Next, he raised consumption taxes such as on tobacco and liquor (Suzuki, 1962, p. 38-39), and he sold government owned companies to the public. The function of the Yokohama Specie Bank became absorbing specie from abroad through handling the foreign bills of exchange connected with exports. This is what it successfully accomplished. The third pillar of Matsukata’s policy was a Central Bank. The Bank of Japan was founded in 1882. The Bank was under tight control of the Ministry of Finance. Art. 24 of the Regulations of the Bank of Japan stipulated that the government could stop activities contrary to the Regulations, as well as activities that are contrary to the interest of the State. The issue of silver-convertible banknotes from January 1886 marked the real start of the Japanese banking and financial system.

In 1883, the National Banking Act was revised to include a clause that a bank’s license could only be renewed if the bank would give up the privilege of note issue. By 1899, the national banks were reformed into ordinary banks, liquidated, absorbed by other banks or wound up by the government. The distinction between ordinary banks, savings banks, and long-term credit banks dates from about 1890, which is when the Bank Decree and the Savings Bank Decree were promulgated (Tamaki, 1995, p. 63, 75, 77, and 104).

The indemnity payments from the Sino-Japanese War enabled the adoption of the gold standard in 1897. China agreed to pay the indemnity in English pounds (£38 million) to the Japanese government in London in a series of instalments. Part of the foreign currency reserve was transmitted to Japan, part was spent as mentioned above for military and naval expansion

procurements abroad. The foreign currency reserve was also used to back large increases in note issue (Allen, 1980, p. 24-27).

As can be understood from the above distribution of the indemnity payments, after the war with China, the government did not plan the return to a peacetime economy. In order to finance its plans, it decided to establish a number of special purpose banks. The Taiwan Bank and the Chosen (Korea) Bank were established for local development. The Hypotec Bank and the Agri-Industrial Bank were both established in 1896 to provide long-term loans to the agricultural and industrial sectors, and Hokkaido Development Bank provided the same services for the development of Hokkaido from 1900 (Tamaki, 1995, p. 98-99; Suzuki, 1962, p. 77).

From 1902, the Japan Industrial Bank started its operations aimed at the development of industrial capital. It also acted as a second specie bank and facilitated foreign investments (especially in South Manchuria), and investment by foreigners in Japan (Suzuki, 1962, p. 77). It sold its own debentures or debentures of public undertakings such as the South Manchuria Railway Company mainly on the London capital market to an amount of about 350 million yen between 1902 and 1911 (Allen, 1946, p. 49).

Japan had financed its war with Russia (1904/05) by accumulating massive foreign debt. Due to World War I, the real interest rates on the world market rose dramatically, and a depreciation of the Japanese yen, enabled Japan to become a net lender by the end of 1919. The Japanese government issued considerable loans to allied governments and China. A large portion of the loans to China had been issued without security, and had to be written off. Loans to Russia were rendered unrecoverable by the Russian Revolution (Flath, 2000, p. 45).

At the end of the Meiji period in 1912, the Sumitomo, Mitsui, Mitsubishi, Yasuda and Dai-Ichi banks had emerged as big commercial banks, and formed the base for the growth of the *zaibatsu*. “The Big Five, with a capital share of 16 per cent, commanded 24 per cent of the total ordinary bank deposits and 21 per cent of the total advances on average in” the years between 1911 and 1919 (Tamaki, 1995, p. 127). From the start of the depression in 1920, the number of ordinary and savings banks declined through mergers and liquidations. This development reinforced the “Big Five’s” positions even more.

The Great Kanto Earthquake in 1923, had disastrous consequences for the banks starting with the loss of many bank records of the 63 percent of the bank offices that were destroyed by fire. To provide relief for the businesses in the affected area, the government imposed a month-long moratorium on the collection of notes and other settlements. When the due date came around, the bill could be taken to a bank to be discounted. Then the bank would present the bill to the BOJ who would rediscount the bill and stamp it with the words “Earthquake Bill”. In case the BOJ suffered a loss from these transactions, the government would guarantee it up to JPY100 million (Nakamura, 1994, p. 28). Many companies were saved in this way, but a considerable part of the Earthquake Bills issued by the banks, seems have been used to finance the

growth of a comparatively small number of companies.[19] As a consequence of the bad bills, a bank run started in 1927, and some 126 banks were closed. The rationalisation movement also promoted bank mergers and thus strengthened the amalgamation trend. The number of ordinary banks declined from 1,280 to 377 between 1927 and 1937 (Tamaki, 1995, p. 154 and 161), and further to 69 in 1945 (Minami, 1994, p. 115). For the securities market and non-banking financial institutions, the banking crisis meant growth.

From the start of the war with China in 1937, the Japanese economy became more and more war oriented. The financial system served to accommodate these policies as a consequence of which the banks were no longer free to determine their own course. The stock market was closed towards the end of the war because shareholder influence on company management decisions and shareholder dividends did not serve the purposes of the wartime government

1945-1980

Inflation soared at 51.1 percent in 1945, 364.5 percent in 1946, 195.9 percent in 1947, and 165.6 percent in 1948.[20] Ishibashi Tanzan, the finance minister, argued that this was not "'true inflation' as defined by Keynes in *The General Theory of Employment, Interest and Money* (demand in excess of supply under full employment conditions). Because resources were idle, much of the population was unemployed, and there was still room to increase production. The way to deal with it therefore was not to suppress demand but to increase production. To do so, Ishibashi advocated 1. using the Reconstruction Finance Bank to channel funds to priority industries, and 2. adopting 'priority production plans' that would encourage production of coal and steel" (Tachi, 1993, p. 33-34). Thus he proposed to drive the economy to full employment.

For the government, the inflation had the beneficial consequence that its wartime debts were greatly reduced. On the other hand, the inflation also did away with a large part of private savings, and thus inhibited large-scale private investment. Wartime financial institutions had been closed for liquidation. The *zaibatsu* banks had been closed and were in the process of being re-organised in accordance with anti-monopoly requirements. Other commercial and special banks were short of liquid funds, and were unable to accommodate many large borrowers. The solution was found in the establishment of public financial institutions.

The Reconstruction Finance Bank (RFB) was established on October 29, 1946 (BOJ Research Department, 1969c, p. 385), and started operations on January 15, 1947. The RFB "was designed as an emergency source of credit for organisations considered essential to production for economic recovery but

[19] For a detailed accounts, please refer to: Tamaki (1995), p. 147-149, and Nakamura (1994), p. 31.

[20] Goldsmith (1983), p. 133. According to Goldsmith, the deficit of the central government equalled 14, 7, and 6 percent of GNP, whereas credits of the banking system to the government amounted to about 8, 13.5, and 5.5 percent of GNP in 1945, 1946, and 1947 respectively. (Ibid. p. 133) The lions share of the burden was borne by the Bank of Japan, or in other words by the printing presses.

which do not have adequate financial condition, record of earnings, etc., to justify the amounts of desired credits from regular commercial banks" (BOJ Research Department, 1969a, p.403). The active life and therefore the loans were limited to a maximum of three years. The idea was that "at the end of that period normal banking facilities must be prepared to assume the full financing burden in all fields" (BOJ Research Department, 1969c, p. 391).

The importance of the Reconstruction Finance Bank can be understood from the following quote: "In just a little over 18 months following the start of operations, the RFB had made loans totalling 82 billion yen. This figure represented over 24% of all loans made by all financial institutions in Japan (BOJ Research Department, 1969d, p. 674). According to Brown, by March 1949, the RFB was supplying 32.3 percent of all bank loans. Furthermore, from its establishment in 1946 through 1949, it supplied 23.8 percent of all bank loans (Brown, 1999, p. 54, and note 2 on p. 247). Loans outstanding had increased from 4,117 million at the end of January 1947 to 48,479 million at the end of January 1948. In March 1948, about 75 percent of its debentures were held by the Bank of Japan (BOJ Research Department, 1969d, p. 659). In other words most of its funds came from the printing presses.

Joseph M. Dodge, an American banker who came to Japan as an advisor to the Occupation authorities in 1949, advocated a balanced budget, reducing Reconstruction Bank financing, and stopping price differential subsidies.[21] In order to curb the inflation, the Dodge Plan was put into force in 1949. This meant that the fiscal budget was drastically tightened. It is clear that the implementation of the Dodge Line in 1949 contributed to reduced government borrowing, monetary base growth rate and government budget growth rate. This caused the growth of GNP to briefly fall until the Korean War gave the economy a new incentive.

The Dodge Plan prohibited the issuing of new debentures by the RFB, and restricted its lending to the industrial field and for capital investment purposes only.[22] The Japan Development Bank was established on April 20, 1950. Initially its main purpose was to refinance RFB loans. On January 16, 1952, the Japan Development Bank absorbed the RFB (BOJ Research Department, 1969, p. 694). It became the important tool for long-term financing in the policies that promoted capital accumulation/investment in key industries. The Industrial Bank of Japan[23] was converted into a debenture issuing long-term credit bank following the Long-term Credit/Trust Bank Law of 1952. The Long-term Credit Bank of Japan also dated from December 1952. Other

[21] The government set official prices of goods lower than their production prices and compensated for the difference with subsidies. Tachi (1993), p. 34.

[22] Operating loans constituted roughly half of the loans to industry. SCAP found that a considerable part of the operating loans was made for deficit financing. In addition, SCAP was concerned that the Reconstruction Finance Committee upon which recommendations the loans were made, practiced favouritism and served political interests. See BOJ Research Department, 1969d, p. 659 and 664.

[23] The Industrial Bank of Japan had been one of the special banking institutions together with the Hypothec Bank and the Hokkaido Colonisation Bank. In 1950 the Industrial Bank of Japan was converted into an ordinary bank, and from December 1952 it became a long-term credit bank again. For reference see Suzuki, (1987), p. 200.

providers of long-term financing were trust banks. Trust funds were similar to fixed deposits with maturities of two to five years (Horne, 1985, p. 29-30).

Other public financial institutions fulfilled their own specific purposes. For example the Export Finance Bank (from 1952 called Export-Import Bank) was established on December 15, 1950 and started operations in February 1951. The Small Business Finance Corporation, the Agricultural, Forestry and Fishery Finance Corporation, the People's Finance Corporation, the Central Bank of Commerce and Industry[24], and the Central Bank for Agriculture and Forestry[25] fulfilled financing tasks oriented towards the constituencies mentioned in their names. Their funds came from the Postal Savings Deposit Fund (Trust Fund Bureau) (Allen, 1980, p. 109-110; Suzuki, 1987, p. 287-288).

Although postal savings had been used by the government for its various purposes including military investments, public spending, and industrial or economic policies on an ad hoc basis since 1885, this route was first institutionalised from the inception of the Fiscal Investment and Loan Program in 1953.

SCAP had ordered closure of many banks, and refused to re-open the stock exchange until 1949. Capital was scarce and Japanese capital markets were strictly regulated. The priority production scheme by finance minister Ishibashi Tanzan directed funds to coal mining, electric power, steel and chemical fertiliser industries. Under the Emergency Financial Measures Ordinance of February 1946, private commercial banks were required to allot 50 percent of their own loans to the so-called priority industries. Thus other industries were left with little access to funds. With few alternatives, over-the-counter trade however, continued vividly.

Since there were few rules governing disclosure or the securities trade itself, many stockholders were basically unprotected and fell victim to scams or their own speculative tendencies. Although it was necessary to open the stock exchanges again, SCAP insisted on the establishment of a Securities and Exchange Law (SEL) and a Securities and Exchange Committee (SEC) after the American model. The idea was that the SEC would supervise securities transactions independently from the MOF. Soon after the Occupation Authorities left, the role of the SEC was reduced to an insignificant office within the MOF.

The Securities and Exchange Law of 1948 provided the rules for the securities and exchange transactions but also established a sharper than ever separation of banking and securities sectors. This part of the legislation was inspired by the American Glass-Steagal Act. Accounting and disclosure guidelines were laid down in the Business Accounting Principles and the Working Rules for Financial Statements.

Following the above developments, at the beginning of the high-growth period the Japanese financial system displayed several characteristics. These characteristics were a consequence of severe capital shortage, the compartmentalisation of the financial system, and strict regulations. Various authors have described and analysed these characteristics in great detail[26], so

[24] 商工中銀 (*shoukou chuugin*)
[25] 農林中銀 (*nourin chuugin*)
[26] See for example Suzuki (1987), and Teranishi (1999).

the following explanation will be brief.

"Over-borrowing" indicated the fact that companies relied primarily on bank loans to finance their operations. The banks extended more credit than they acquired from deposits or their own capital. Banks therefore borrowed most of this difference from the Bank of Japan. This situation was referred to as "over-loan". In addition, an inter-bank market developed where city banks borrowed the surplus funds from regional banks, mutual savings banks, credit co-operatives and other financial institutions. Interest rate controls and restrictions on foreign exchange transactions inhibited the development of open bond markets. On the other hand, interest rate controls together with the segmentation of various types of financial institutions prevented destructive competition (Suzuki, 1987, p. 21-25).

Compartmentalisation of the financial system facilitated control by the Ministry of Finance. The government (starting with SCAP)[27] kept interest rates as low as possible, in order to keep the cost of capital low and price levels stable. Over-loan gave the Bank of Japan the opportunity to impose credit ceilings and indirectly influence the city banks' lending behaviour, especially in times of tight money. Window guidance in its simplest form imposed penalty discount rates on banks that surpassed their borrowing (and indirectly their lending) quota (Nakamura, 1981, p. 149).

Some claim that the Ministry of Finance used window guidance "to direct capital to key industries".[28] In the period until about 1973, keiretsu companies relied heavily on their main banks or lending consortia headed by their main bank. As the main banks were involved in monitoring the companies, it is possible that the MOF may have had some indirect influence through the main banks. Whatever, the degree of success of these policies may have been, it is clear that it is the individual savers and investors were the ones losing out in the Japanese financial system.

Nominal Japanese interest rates until about 1970 were higher than US interest rates. However, after adjustment for inflation, the real interest rates in Japan were lower than in the USA. Due to restrictions at the Japanese financial markets, foreign capital could not freely enter. Therefore, interest rate controls were sustainable.

The low interest rates were a pity for depositors at city banks and the postal system[29], but they had few options. They could not invest in government

[27] The Temporary Interest Rate Adjustment Law of December 1947 gave the government the authority to regulate interest rates in order to prevent interest rate competition in order to ensure profitability of financial institutions on the one hand, whilst suppressing so-called 'unfair' lending rates, on the other. See Suzuki (1987), p. 41.

[28] For example Brown (1999), p. 55. Furthermore, Tachi (1993, p. 82) writes: "It was easy for government authorities to control the economy. Corporations (…) were forced to depend on loans from financial institutions, so all the authorities had to do was exert pressure on institutions to make the entire economy fall into line." Although on p. 91 he claims as follows: "Then there is 'moral suasion' – direct regulation, 'window guidance', and lending ceilings that are used to control increases in the lending of private institutions, but are not coercive. Institutions do not have to follow moral suasion if they do not want to, but since the Bank of Japan is their lender of last resort, it is hard to ignore."

[29] Postal saving ordinary deposits yielded 3.96 percent until 1960. From 1961 until 1971, the interest rate on postal savings was 3.60 percent. Goldsmith (1983), p. 155.

bonds for they hardly existed due to a balanced budget policy, and the ones that existed were held by financial institutions. In addition to that, there was no secondary market. A possibility was trust bank deposits. In 1954 and 1955 the five year deposit interest rate was 9 percent. From 1956 until 1973 it was about 7 percent (Goldsmith, 1983, p. 155).

Securities markets remained underdeveloped and played a secondary role in the financing of companies and the investment of savings alike. As explained elsewhere in this chapter, tax incentives promoted savings in the form of bank deposits. Most companies adhered to the practice of paying stable dividends of 5 yen per share. Until the first oil shock most shares were issued at a face value of 50 yen per share, and gratis distributions were very common practice.

The percentage of stock-ownership by financial institutions and business companies increased considerably in this period. The practice of purchasing stocks for the purpose of mutual shareholding by banks and business corporations served to strengthen former *zaibatsu* ties into *keiretsu* or business groups. It is generally assumed that the reason was that Japanese companies wanted to protect themselves against national and especially foreign hostile take-overs when Japan joined the OECD in 1964 and agreed to liberalise its financial markets (Okumura, 1999, p. 123).

A characteristic of the reciprocal shareholding system was that dividends could stay low because it would only make the cost of equity capital higher for each other to raise dividends. Minority shareholders did not have enough clout to demand higher dividends. Ever decreasing yields and a declining percentage of individual investors were the consequence. Since the 1962 revision of the Commercial Code, restrictions on dividend payments consisted of deferred start-up expenses, organisation expenses, bond issuing expenses, and R&D expenses (CC Art.286).

The Anti-Monopoly Act of 1947 limited stock ownership by banks to 5 percent of a company's total stock. In 1953, this rule was changed to 10 percent (Okumura, 1999, p. 122). In 1977 the limit was set at 5 percent again, but for the period presently under discussion it is important to note that banks could hold up to 10 percent of a company's stock. The fixed nature of corporate stockholdings can be illustrated as follows. In 1975 sales by individuals accounted for 61.4 percent of the total sales of stocks at the Tokyo Stock Exchange, and for 59.8 percent of the purchases. Corporations accounted for 15.7 percent of the sales and 15.8 percent of the purchases (Tokyo Stock Exchange, 1998, p. 220-221). At that time corporations (including financial institutions except for securities companies and investment trusts) accounted for 62.3 percent of total stockholdings.

The equity to total capital ratio improved to 39 percent in 1955. Personally I think that because of the Korean War boom many companies issued new shares. Perhaps especially the companies that were not in priority industries and that also wanted a piece of the pie. However, the enormous rate of plant and equipment investment could not be sustained by equity capital alone. Therefore, the average equity ratio deteriorated again to 20.7 in 1960, 19.0 in 1965, 16.1 in 1970, and 13.9 percent in 1975 (Nakamura, 1981, p. 64, 65, 249).

Together with the increase in the percentage of stable stockholders such as financial institutions and business corporations, the declining equity ratios indicated the growing importance of banks.

Yields on listed stocks (ratio of annual dividend to current price of a stock) decreased from 9.44 percent in 1954 to 3.93 in 1960. They gradually increased again to 5.92 in 1965. At 3.37 percent the yield on stocks fell under the postal savings deposits and stayed lower throughout the rest of the 1970s (Goldsmith, 1983, p. 155). Knowing that dividend income was and still is taxed, whereas interest income from postal and bank savings was largely tax-exempt (see above), it is understandable that the stock markets lost their attraction to individual investors.

Bond markets too developed slowly. Due to a balanced budget policy until 1965, the government scarcely issued bonds from 1949. The Bank of Japan bought back most government bonds before their maturity. Until 1973 public sector deficits were small and financial institutions had no problems absorbing the bonds, nor did the Bank of Japan. Corporate bonds had to be backed by collateral, a practice dating from the 1920s. In the four years up to 1973, the amount of convertible bonds doubled every year. From then until the time that the level of stock prices showed clearly no sign of recovery convertible bonds remained extremely popular. Another factor that influenced both the Japanese economy and the financial system were the fixed exchange rates within the Bretton-Woods system. The collapse of this system in 1971 created opportunities for arbitrage and the use of new products.

As mentioned above, the first oil shock marked the start of fiscal deficits. In its wake economic growth slowed down. This was also a period where companies increasingly relied on retained earnings. Investment halted. Even in the case of external financing, companies increasing sought and found access to sources other than bank loans. Managers were finally able to dispense with compensating balances and strict bank monitoring.

Deregulation progressed in response to domestic pressure for reform as well as external pressure to open up Japan's financial and capital markets.[30] In 1980 the Foreign Exchange and Foreign Trade Control Law was revised to liberalise cross-border transactions. Particularly in 1984 with the abolition of regulations on yen conversion and the liberalisation of Euro-yen transactions, Japanese companies' access to international financial markets improved drastically.

A secondary market for government bonds was opened in 1977 as a result of a large increase in deficit bonds, but only developed in the 1980s. The issuance of corporate bonds required government permission and a large amount of collateral. Therefore only a few very large companies could issue bonds. In 1979 the bond eligibility criteria for unsecured bonds were so strict that only Matsushita and Toyota qualified (Campbell and Hamao, 1994, p. 330).

1980-1996

During the 1980s companies were increasingly allowed to issue unsecured

[30] For a description of the deregulation process see Hall (1998), p. 20-25.

bonds, for which bond-rating agencies were first established in 1985. Japanese companies were able to issue warrant bonds overseas earlier than at home. They issued massive amounts of warrant bonds with low coupon rates abroad. Due to the expectation of a rising yen in the late 1980s, companies used forward contracts for the bond principal at maturity. This construction reduced the principal amount (Hoshi and Kashyap, 2001, p. 232). Arbitrage activity between the regulated domestic and unregulated offshore markets resulted in deregulation of Japanese bond markets. Further deregulation of the Japanese system occurred in reaction to the need for financial intermediaries to offer more competitive rates of return to their asset holders (Teranishi, 1994, p. 112-115).

After the Plaza Accord in 1985 the Japanese government gradually lowered the discount rate from 5 percent to 2.5 percent in order to increase the value of the yen towards the dollar. In hindsight that is what started the speculative asset-inflated bubble economy. A raise in the discount rate in May 1989 is what punctured it. The Bubble economy its causes and consequences have been extensively described by other scholars (Teranishi 1994; Cargill, Hutchinson, and Ito 1997). During the asset inflation years, securities prices and land prices increased disproportionately to the prices of other assets and thus fed the bubble. Banks, other financial institutions extended loans backed by inflated collateral. When the bubble burst many of these loans went sour, thus destabilising the banks as well as the whole financial system.

In Japan generally dubbed “the Lost Decade”, this period has shown deregulation of the financial system at a pace and to an extent never seen before. However, the bad loan problem has not been solved, nor has the economy been resuscitated. Interest rates are still close to zero, and over the past few years, deflation has been threatening to aggravate the bad loan problem. The number of corporate bankruptcies has been growing, creating new bad debts in addition to the already existing ones.

What did happen during the lost decade? The Nikkei Stock Index came down from 38,915.87 in 1989 to 23,848.71 in 1990. The trend was downwards after that except for 1994, 1995 and 1996 when it returned to over 19,000. In the past three years the level has been particularly low, 13,785 in 2000, 10,542 in 2001 and in the last week of November 2004 it reached 8,300 to go up again to about 11,000 in April 2005. Disposal of cross-shareholdings is causing supply to surpass demand. Poor corporate performance is further reducing the appeal of investment in stocks.

Initially lending declined as a consequence of the bad loans. Since 1995 the government has been keeping interest rates at near zero percent. Banks are not eager to lend out money as it will not generate satisfying returns, and because they are struggling with their bad loans. With the current zero interest rate policy, bond prices are not expected to rise and are therefore not attractive to invest in.

Non-performing loans constituted a problem of which the size and impact remained shrouded in clouds even to the regulatory authorities for too long. As late as 1994 estimations on the size of the bad loan problem were based on disclosure banks rather than independent audits. In addition, the definition of non-performing loans reported on bank financial statements

included loans to borrowers in legal bankruptcy, and loans on which no interest or principal payments have been received for six months or more.[31] From 1995 to 1999, the definition of bad loans was broadened every year. The MOF's indecisive attitude stemmed from the hope that stock and land prices would recover (Cargill, Hutchinson and Ito, 2000, p. 48-49).

In June 1995, the size of the *jûsen* problem (the bad loans at the seven housing corporations of which many were affiliates of the city banks) made it clear that the hitherto taken stance of forbearance had severely endangered the stability of the nation's financial system. Forty-nine percent of the total assets of the seven housing loan companies turned out to be bad loans. A total of JPY6,273,800 million was classified as unrecoverable (Shikano, 2001, p. 147). Another 25 percent were estimated to be non-performing. From the summer of 1995 Japanese banks borrowing funds at the international capital markets had to pay a "Japan premium".

1996-2003

In 1996, about JPY6.41 trillion of the bad loans of the jûsen were written off. The losses were borne by the founding institutions (JPY3.5 trillion), other financial institutions (JPY1.7 trillion), agricultural co-ops (JPY0.53 trillion), and the taxpayers (0.68 trillion) (Hoshi and Kashyap, 2001, p. 269-271). The remaining assets were absorbed in the Jûsen Resolution Corporation, established in June 1996, whereas the housing loan companies were liquidated. In November 1996 Hanwa Bank was closed. Its assets were sold to the Deposit Insurance Corporation, and the Resolution and Collection Bank (successor to the Jûsen Resolution Corporation) was left with the task to recover the non-performing loans. Prime Minister Ryutaro Hashimoto announced a thorough deregulation of the financial system in November 1996.

The Big Bang as the plan was popularly called, aimed at making the Japanese financial markets free, fair and global, at par with financial markets in New York and London. Deregulation was to be completed by March 2001. "Free" stands for a market shaped by the market principle. By that time the segmentation that had characterised the system for many years was supposed to have disappeared in order to free the range of products and financing methods for investors, savers and companies. The rules according to which transactions are to be carried out should be "Fair" and transparent. "Global" refers both to the degree of access as well as the level of standards governing transactions, disclosure and legal framework of the financial system (Horiuchi, 2000, p. 234). An overhaul of the accounting and disclosure system dubbed "the Accounting Big Bang" between 1998 and 2001 provides a disclosure framework largely level with the International Accounting Standards.

Formally, liberalisation of the financial system has indeed been completed on schedule. However, dealing with the faltering banks and the disposal of the bad loans has been lagging behind schedule to a worrisome extent. November 1997 saw the collapse of Sanyo Securities, the Hokkaido Takushoku Bank, and Yamaichi Securities (which the MOF allowed to be

[31] This was the definition until fiscal 1995. See Ueda (2000), p.60.

purchased by Merrill Lynch). Immediately the Japan Premium soared (Cargill, Hutchinson and Ito, 2000, p. 58). In December 1998 nationalisation of the Long-Term Credit Bank and the Nippon Credit Bank heightened the sense of crisis because of the departure of the convoy-system and the idea that there are banks that are “too big to fail”.

Two capital injections took place in March 1998 and March 1999 respectively. The 1998 injection was criticised for being non-discriminating and ineffective. In March 1999 the standards for securing public funding were higher and banks had to submit reorganisation plans. As a consequence several mergers and acquisitions took place in the wake of which there are presently only four large city-banks left. Between April 2001 and March 2003 banks such as Sakura Bank, Sumitomo Bank, Asahi Bank, Daiwa Bank, Sanwa Bank or Dai-ichi Kangyo Bank all disappeared and merged in order to survive. As a consequence of the financial big bang, there are fewer bank offices nowadays, they bear names like Mizuho, Mitsui-Sumitomo (SMBC), UFJ, and Resona, and they are all part of different holding companies.[32] The Bank of Tokyo-Mitsubishi was the only one that was already in 1996 the result of a proactive merger between the Bank of Tokyo and the Mitsubishi Bank, in rare anticipation of things to come.

The wave of mergers extended itself to trust banks and insurance companies. Hoshi and Kashyap (2001, p. 297) make the observation that these mergers serve to create stronger positions bridging the traditional segmentation of the financial system. In part these mergers may be understood as a defence against foreign firms with many years of experience offering a broad range of products and services.

In December 2004 the FSA issued its plans for Japan’s financial system in a document called *Moving Toward a Financial Services Nation*. The FSA will strive to strengthen the competitiveness of Japanese financial markets and their international position. It aims to enhance market functions and improve confidence in markets. Furthermore, it seeks active participation in international standard setting activities.[33]

2.4. Taxation

Taxation is one of a national government’s prime concerns with financial accounting. Governments depend in a large part on taxation for their revenues with which they can draw up budgets. A government can use these revenues to invest in infrastructure or other projects through which they can build up its country or stimulate the economy. It can also use tax credits, accelerated depreciation or other taxation measures to stimulate investment in general or even in productive capacity or research and development in certain industries. Traditionally, taxable income equalled business income. Increasingly countries are now determining taxable income separately because of the disturbing effect that taxation may have on business income, business investment, as well as on

[32] Holding companies had been banned until 1997.
[33] See FSA homepage: www.fsa.go.jp

the valuation and depreciation of assets for business purposes.

1868-1945

Before the Meiji Restoration, the Japanese Tokugawa administration levied taxes mostly in kind (rice) from the about 75 percent of the population that was engaged in agriculture, and forced contributions from merchants and artisans in the form of gold or silver.[34] The *Boshin* Wars (Restoration Wars) against Tokugawa Yoshinobu, the 15th and last shogun of the Edo period, who resisted the new government, ended in May 1869 (Ishii *et al*., 1998, p. 237). War expenses left the new government with a deficit of about JPY27 million, and the need to revise the tax system (Sato, 1997, p. 194-195).[35] At that time the local *han* governments still preserved financial autonomy. "With the abolition of the *han* the Government assumed responsibility for local administration. Although the revenues which the *daimyo* had previously received from their subjects were henceforth due to the central exchequer, it was not easy at first to ensure the collection of these sums" (Allen, 1946, p. 34-35). Furthermore, the fact that the state also took on the responsibility for the notes that had been issued by the *han* governments added to its financial difficulties.

In 1871, the tax system was changed to a money-based system. In 1875, the distinction between regional tax and national tax was established. At that time regional tax constituted 82% of total government revenue (Masakuma, 1976, p. 28). The introduction of land tax instead of crop tax was a painful process. It took from about 1873 to 1880, when the rate was finally fixed at 2.5 percent of the value of the land (Sato, 1997, p. 194-195). In 1877, the Satsuma rebellion broke out. In order to finance the military expenditures, the government issued notes to the amount of 27 million yen and took on a bank loan of 15 million yen.[36] According to Tsuru, the inflation following the Satsuma rebellion caused a general price rise of 60 percent in the period of four years (Tsuru,

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[34] In 1872, about 77 percent of the population was engaged in agriculture. See Allen (1946), p. 57. In 1622 the population consisted for 87.3 percent of peasants, 2.7 percent townspeople, 5.3 percent samurai, and 4.7 percent others. See Ishii *et al.* (1998), p.173. Nakase claims that the tax payments were actually mostly in gold and silver directly based on the rice price. Nakase (1990), p. 73. This certainly makes sense for logistical reasons. Furthermore it is interesting to note that in the *Heian* and *Muromachi*, periods Chinese bronze coins were used as currency. Although the people in Japan possessed both the technology and the resources to mint their own coins, the Imperial Court of Japan only minted twelve types of copper coins between 708 and 958, and they were not commonly used as currency. Under the China-centred world order, the Chinese coins commanded general acceptance, and therefore Japan imported the Chinese coins in exchange for Japanese gold. By the *Muromachi* period (1338-1573) the private sector minted imitation Chinese coins in addition to the imported ones. When around 1430 China stopped minting coins, lack of supply caused deterioration of the coins. From the end of the 16th century the Japanese rice yields increased, rice became one of the means to settle payments. Tokugawa Ieyasu placed the major gold and silver mines under government control and set out to establish a unified currency system in the beginning of the 17th century. See Miyamoto and Shikano (1998).

[35] According to Minami (1991), p. 15, central government expenditure amounted to 30 million yen, whereas revenue was only 3 million yen. Allen (1946), p. 34, states that the amounts were 25 million and 3.7 million yen respectively.

[36] Allen (1946), p. 37. Ironically, the bank loan was wholly supplied by the Fifteenth National Bank, also known as the Peer Bank. Tsuru (1995), p. 51.

1995a, p.10-11).

Matsukata's deflationary policy, and the military expansionist line followed since the Ningo Military Troubles (*Ningo Gunran*), in Korea in 1882, led to an increase in tobacco and liquor taxes in December (Sato, 1997, p. 198-199).[37] The institution of the "Income Tax Law" in 1887, established a national instead of a regional income tax system. The regional business operation tax (営業税) of 1878, became a national tax in 1896 following the war with China. The Business Operation Tax Law applied to twenty-four kinds of businesses including trading, manufacturing, insurance, banking, transportation, and brokerage companies (Sato, 1997, p. 202).

The Business Operation Tax Law and the Income Tax Law are probably the first national laws that included accounting standards on measurement of assets, and the calculation of profit. Business Operation Tax was abolished in 1926, and replaced by Business Operation Income Tax[38] (Masakuma, 1976, p. 31). Corporation Tax was established in 1899 as a part of Income Tax (Sato, 1997, p. 202). In the same year, the new Commercial Code was promulgated. The Commercial Code contained accounting provisions to which we will refer later. However, it is important to note the relation between the various tax laws and the Commercial Code, as final tax returns were based on accounting according to the Commercial Code.

Tax increases accompanied military operations, especially when Japan entered the war with China in 1937, and in the course of the Second World War. During the first three months of the war with China, the government already spent the same amount as a whole year's national budget on military expenses. The Marco Polo Bridge Incident on July 7, 1937, was followed by the Special Taxation Law Concerning the Kitashi (Northern China) Incident[39]. And the China Incident was followed by the Special Taxation Law Concerning the Japan-China Incident[40] in 1938 (Masakuma, 1976, p. 31-33). In 1940, the tax system was simplified and revised. Corporation tax became separated from Income Tax. In turn, Business Operation Profit Tax was abolished. The wartime control economy was characterised by high tax rates, and by many special taxation laws for industries and regional authorities.

An interesting detail is that income from Liquor Tax increased from 285 million yen in 1940 to 1,131 million yen in 1945. During the same period Corporation Tax increased from 182 to 1,162 million yen, and Income Tax from 1,489 to 3,820 million yen. The total revenue from taxes increased from 3,653 to 10,152 million yen (Sato, 1997, p. 250). It makes one suspect that either the sake consumption increased during the war period, or that the increased excise taxes did not deter people from maintaining a certain consumption level. Either way, until 1908 land tax accounted for the larger part of national taxes, after which the main source became indirect taxes such as those on alcoholic beverages.

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[37] The *Ningo Gunran* would finally lead to the Sino-Japanese War in 1894-1895.

[38] 営業収益税

[39] 北支事件特別税法

[40] 支那事変特別税法

1945-1980

In April 1949, professor Carl S. Shoup of Columbia University visited Japan in order to investigate Japan's tax system. The Shoup Mission recommended that personal and corporate income taxes account for 50 to 60 percent of government income. Before the larger part of government income came from indirect taxes such as liquor tax and customs duties (Tachi, 1993, p. 111). Furthermore, it emphasised equity and fairness of the system embodied in progressive and broadly based income taxes as the mainstay of the Japanese tax system. Other aspects were decentralisation and improvement of tax administration and revaluation of all assets in order to correct the consequences of inflation (Ishi, 2001, p. 27-29). At the same time taxation of share premium was abolished.

Modifications of the Shoup tax system were implemented soon after 1950 as a result of which "equity was sacrificed for the conveniences of incentives and administration" and the tax burden of big businesses was reduced in order to promote capital accumulation (Ishi, 2001, p. 29-30). The Enterprise Rationalisation Promotion Law of 1952 established a special depreciation system for important machinery thereby reducing the tax burden for new investments in plant and equipment. Other tax measures included a separate tax on interest and dividend (1951), and abolition of the tax on the reserves of non-family business firms (1952) (Nakamura, 1981, p. 44).

Not only did the Shoup Report have an enormous impact on the Japanese taxation system, it also exerted a profound influence on the development of the accounting system. The recommendations in the Shoup report included the establishment of:

1. a certified public accountant system
2. a Securities and Exchange Committee
3. a body to issue accounting standards within the National Tax Bureau
4. an accounting curriculum at Japanese universities (Arai, 1999, p. 213-215)

One of the main problems was that there were not enough people with the qualifications to implement and effectively operate a modern corporate taxation system.

From about 1950 to 1973, there was wide agreement that the system of taxation should serve and promote economic growth. Computation of taxable income based on the accounting standards of the Commercial Code, supplemented by the Business Accounting Principles and the tax laws did not create any discord for any of the parties involved. Among others, Arai (1999, p. 219) calls this the "honeymoon period".

Between 1951 and 1961, the Special Tax Measures Law allowed accelerated depreciation for designated equipment purchases. Companies in targeted industries could write off 50 percent of the purchase price of designated machinery in the first year, followed by 20 percent per annum in the next two years. Initial depreciation of one third of the purchase price was allowed from 1962, and one fourth from 1964. Eventually, this system was abolished in 1973 (Flath, 2000, p. 202-203).

Furthermore, between 1953 and 1963, export industries enjoyed tax exemptions for the lower of 50 percent of export income or 3 percent of total

manufacturing sales (Flath, 2000, p. 203). Between 1955 and 1961, automobile and steel industries benefited most from the special depreciation measures. Shipbuilding and machinery industries benefited a little less. Between 1962 and 1973 again automobile and steel industries benefited most, although special depreciation expenses were smaller than in the previous period. Ogura and Yoshino (1988) estimated that the present value of special depreciation amounted to between 0.5 and 4 percent of investment expenditures annually for these industries.

From April 1, 1961, a split-rate system was introduced to make it easier for companies to raise equity capital and thus reduce reliance on debt. The general tax rate on profit retentions was 38 percent whereas profit distributions were taxed at 28 percent. If profits were below 2 million yen the applicable tax rates were 33 and 24 percent respectively. From 1966 these reduced rates only applied to companies with profits below JPY 3 million and with a capital stock of no more than JPY 100 million (Ishi, 2001, p. 120 and 173, table 10.3). Corporation tax, enterprise tax, and residents tax together make up the total taxes paid by companies in Japan. Tax rates including these regional taxes amounted to 48.6 percent in 1965, increasing to 48.7 percent in 1973. US companies had to pay 49.5 percent in 1965 and 50.5 percent in 1973 (Tajika and Yui, 2000, p. 118).

In addition to promotion of investment, the government also aimed to stimulate household saving by reducing individual income tax, allowing special deductions for interest and dividend income and for capital gains on the sale of securities. Other favourable treatments included low tax rates on interest, tax exemption for capital gains (until 1988), and special treatment of dividends, insurance, housing investments and pension funds. It is not clear whether tax incentives have indeed affected the level of personal savings. However, Japanese households seem to have a preference for savings deposits over life insurance and pension plans or shares.[41]

Fiscal deficits emerged after the first oil shock. Corporate tax rates were raised in an attempt to avoid heavier reliance on government debt. Only in 1986 did the MOF reduce nominal corporate tax rates. The difference between the nominal tax rate and the actually paid tax rate seems to have been the largest for companies with a paid-in capital of over JPY10 billion. According to Ishi medium-sized companies had the least opportunities to benefit from tax-free reserves and accelerated depreciation. Accelerated depreciation decreased in importance whereas tax-free reserves and tax credits for experimental and research expenses became more important. Nevertheless, actual tax rates continued to increase until 1988. (Ishi, 2001, p.195, table 11.2)

1980-1996

April 1990 saw the re-introduction of a single corporate tax rate at 37.5 percent for both profit retentions and distributions. The reduced corporation tax rate by then applied to corporations with a capital stock of no more than JPY 100 million, and profits less than JPY 8 million (Ishi, 2001, p. 173). During the high-growth

[41] Ishi (2001), p. 77, 140, and Chapter 8 for a full description of taxation of investment income and savings.

period it seemed that amendments to the Corporation Tax Law incorporated the accounting rules of the SBAP and the Commercial Code without any problem. Towards the end of the era, economic growth was no longer the universally shared single adagio. The different purposes of the tax laws, the Commercial Code and the Securities and Exchange Law had become more pronounced. The SBAP had become to be associated with accounting under the Securities and Exchange Law, of which the main purpose was investor protection and information disclosure for investment decisions. For the Commercial Code it was creditor protection and accountability. On the other hand, the Corporation Tax Law and the other tax laws had become increasingly concerned with collecting taxes based on the principles of neutrality and fairness (Inoue, 1997, p. 55-56).

During the Heisei recession, the need for revisions of the tax system became more apparent. Had the bond dependency ratio (the ratio of national bonds to government expenditure in the general account of the national government) been about 10 percent in 1990, it stood at about 28 percent in 1995 and at around 43 percent in 1999 (Ishi, 2001, p. 323, fig. 17.1). The 1990s saw large-scale individual income tax cuts and increased government spending in order to promote economic growth. Neither was very successful.

1996-2003

Because of the large government deficit, consumption tax was raised from 3 to 5 percent as of April 1997. It seems that 1997 was a particularly dramatic year with a debilitating effect on the economy. Failure of major financial institutions such as Hokkaido Takushoku Bank and Yamaichi Securities Co. generated a sense of crisis. The bad loan problem added weight to the call for revision of the tax system.

Banks needed to write off huge amounts of bad debt. However, the then existing system made it hard to write off large amounts at a time. Hence the introduction of tax effect accounting in fiscal 1998. At the same time the corporate tax rate was reduced from 37.5 percent to 34.5 percent, and further to 30 percent in 1999. This reduction was motivated by the desire to make the corporation tax level internationally comparable and thus create a level playing field for Japanese enterprises competing on international markets. Measures to broaden the tax base by eliminating exemptions, deductions and credits are still being considered.

The second major revision entails another new feature of Japan’s corporate taxation system, to be named taxation on a consolidated income basis. Due to netting off profits and losses of companies within the consolidation, it is expected that the group as a whole will have to pay lower taxes. Together with the lower tax rates mentioned above, these measures are hoped to have a positive effect on companies’ performance and investment, and thus stimulate the economy. However, consolidated taxation is not mandatory; companies can opt for the new system, once having made the choice they can not go back to the unconsolidated taxation system.

In addition to an ailing economy, Japan is also facing the problem of an ageing society with the working population peaking in 2005, and with ever increasing medical expenses. A solution will probably be found in creating a

composition of direct and indirect taxes that better accommodates the needs of the present day Japanese society.

Ever since the establishment of accounting regulations and the tax system, the relation between accounting standards and the tax system has been strong due to the system of definite settlement of accounts (*kakutei kessan shugi*). This is one of the main reasons that Japanese financial reporting and management gave priority to minimising tax expenses over decision-usefulness of their financial information. As of the year 2000 tax effect accounting applies, and this problem will be expected to disappear.

Although income tax was instituted as early as 1887, at the time it contributed only to 1.5 percent of total national tax revenues. After World War 2, Carl S. Shoup recommended a tax plan placing more importance on direct taxation. Because Shoup's comprehensive income taxation system was too progressive in the eyes of Japanese tax administrators, it was only short-lived and it quickly eroded when the American Occupation ended. The one thing that did remain was the higher dependence on direct taxation in the form of individual and corporate income taxes.

After Shoup's modification of the system corporate income taxes bore the lion's share of national tax revenues during the high growth period, whereas the share of individual income taxes was higher during and in the aftermath of the Bubble period. (See Table 1) It is also interesting to note that the share of indirect taxes is on the rise again. A consumption tax (VAT) of 3 percent was introduced in 1989. In 1997 the rate was raised to a still very moderate 5 percent. Local taxes show similar patterns except that the share of revenues from taxes on wealth is substantially higher (Ishi, 2001, p.9).

Table 1. : Sources of national tax revenues

	1950	***1960***	***1970***	***1980***	***1990***	***2000a***
National taxes						
Taxes on income	***54.4***	***53.6***	***64.3***	***69.5***	***70.7***	***56.5***
Individual	***38.8***	***21.8***	***31.2***	***38.1***	***41.4***	***36.9***
Corporate	***15.6***	***31.9***	***33.0***	***31.5***	***29.3***	***19.6***
Taxes on consumption	***43.4***	***42.2***	***30.9***	***25.2***	***22.0***	***36.9***
Taxes on wealth	***2.2***	***4.2***	***4.9***	***5.3***	***7.3***	***6.6***
Total	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***

Source: Ishi, Hiromitsu (2001), table 1.3, p.9. 2000a: estimated percentages.

From the above, it follows that income has been taxed rather heavily in Japan. The corporate tax rate as proposed by Shoup was a flat rate of 35 percent. In 1958 the tax authorities introduced a split rate system with different rates for profit retentions and profit distributions. Since 1990 there is a unitary rate again, and it has been dropping from 37.5 percent in 1990 to 34.5 percent in 1998, to 30 percent in 1999. In addition companies have to pay regional taxes consisting of enterprise tax and inhabitants tax. Thus the total tax rate on corporate income has been just below or somewhat over 50 percent. Until 1986 the situation was similar in the United States, but there the total tax rate dropped until about 40 percent in 1993 and to 34 percent in 2000.

Judging from Japan's high tax rates on corporate profits and its high

dependence on corporate and individual income, one would expect that tax levels (including social security contributions) as a percentage of GDP will be high as well. Surprisingly, this is not the case. The level for Japan has been about the same if compared with the USA, but is low if compared with Northern European countries. See Table 2 below.

Table 2: Tax revenues including social security contributions as a percentage of GDP

Country	***Japan***	***USA***	***UK***	***Netherlands***	***Denmark***
1970	***19.7***	***27.4***	***36.9***	***37.1***	***40.4***
1980	***25.4***	***26.9***	***35.3***	***45.2***	***45.5***
1990	***31.3***	***26.7***	***36.4***	***44.6***	***48.7***
1995	***28.5***	***27.9***	***35.3***	***44.0***	***51.3***

Source: Ishi, Hiromitsu (2001), table 1.2, p.7.

Ishi mentions several explanations for the relatively low tax burden in Japan, such as the absence of military expenditures, a low level of welfare commitments, and the prevalence of direct taxation rather than indirect taxation (Ishi, 2001, p. 24-25). However, tax revenues as a percentage of GDP in the USA stands at about the same level as Japan, and the USA does bear large military expenditures. The modest level of welfare commitments and contributions in Japan is probably more important. In addition, VAT in EU countries is around 18 percent and therefore much higher than in Japan, so it is possible that the difference in indirect taxation accounts for part of the difference in tax burden.

High income tax rates combined with application of the definite settlement of accounts principle have created a rationale to keep corporate profits low, and concentrate on market-share and turnover as measures of performance. (*kakuteikessanshugi*) as it is called in Japanese, is based on Corporation Tax Law Art. 74, which says that taxable income should be computed on the basis of corporate profits reported under the Commercial Code, and approved by the general shareholders meeting. This means that taxes during the period to which this research applies, taxes have been levied on the basis of the unconsolidated financial statements issued following the accounting rules for computing corporate profits in the Commercial Code. Tax collection based on consolidated profits, and tax effect accounting, were introduced as part of the Accounting Big Bang.

2.5. Corporate governance

The relation between corporate governance and accounting and disclosure standards centres on accountability, and the problems that arise from information asymmetry between corporate managers on the one hand and investors and creditors on the other. This situation is further complicated by the fact that financial statements have to satisfy the partly different information needs of investors and creditors. Large creditors such as banks make use of collateral, compensating balances and debt covenants to reduce the risk of their stake. Informal private information exchange seems to play an important role. Residual beneficiaries such as shareholders have to rely on public financial and

other disclosure, and on their right to choose and dismiss the members of the board of directors. Types of shareholders may also make a difference. For example if a large part of a company's shares are owned by foreign investors, that company is likely to be more forthcoming with financial and other information than if a large part is owned by a block of investors in the same company group. Capital structure, ownership structure, and company groups such as *zaibatsu* and *keiretsu* constitute the main topics for this paragraph.

1868-1945

At the beginning of the Meiji period, modernisation and industrialisation were deemed necessary to make Japan a rich country with a strong military to avoid colonisation by and attain equality with the West. Initially, the government involved itself in numerous industrial and mining ventures that co-existed with an even much larger number of privately owned enterprises in various industries. Although important for diffusing imported technologies, most of these government-owned ventures were still loosing money in the 1870s. Already heavily burdened by the expenses for the Satsuma Rebellion and the former samurai bond payments, the government announced to sell off its non-strategic ventures on November 5, 1880 (Reischauer and Craig, 1989, p. 145-151). Due to lack of capital most were sold at prices that were much cheaper than the original investments to businessmen or government officials that were closely associated with the Meiji government leaders. In the next few years many of these businesses became profitable. Most of them were in the hands of only a few owners. The Meiji government seems to have stimulated oligopolistic mergers and cartel-like organisation of industries in order to reduce competition (Reischauer and Craig, 1989, p. 155; Allen, 1946, p. 126-128).

Japan's belligerence and imperialism, and government procurement during World War 1 contributed to the growth of heavy industries and industrial output, as well as a trend towards concentration. Concentration took place very rapidly during the Taisho period (1911-1926) and led to a dual structure. Small companies constituted the majority of all firms (71.1% in 1929), but their capital represented only a small part of the total (3.2% in 1929). Large firms occupied 1.6% of the total number of firms, but accounted for 65.1% of total capital in 1929 (Yamamura, 1974, p. 110-111). Among them were many companies not controlled by any zaibatsu. Financial crisis in 1927 was followed by the rationalisation period, lasting from 1930 until 1937. Rationalisation brought more cartels for the large firms and industry associations for the small firms. The rationalisation period was also the period in which the "*zaibatsu* established control over industry through control of the banking system" (Minami, 1994, p. 114). Bank credit was the principal source of capital for Japanese industry, and equity markets were illiquid and not well developed. The four largest *zaibatsu* (Mitsubishi, Mitsui, Sumitomo, and Yasuda) owned about 25 percent of the paid-in corporate capital at the end of World War II (Ito, 1992, p. 179; Minami, 1994, p. 114).[42]

[42] According to Allen (1965, p. 177), "in 1937 the 'Big Four' owned 15 per cent and the ten leading zaibatsu owned 25 per cent of the total paid-up capital in heavy industries, in 1946, the proportions were 32 and 49 per cent. In finance and insurance, the corresponding figures were,

The families owning Mitsui and Mitsubishi initially organised their firms as limited partnerships to reduce their potential liability and preserve the family nature of the companies. The companies within these zaibatsu relied on internal financing within the group, or as Masaki called it: “closed financing”. Instead, non-zaibatsu firms were forced to use the capital market and depend on banks due to lack of internal funds.

Around World War 1, first Mitsui and Yasuda followed by Mitsubishi and Sumitomo established holding companies. Then the zaibatsu companies started to reorganise their businesses into separate corporations of which the holding company owned all or most of the stock. In the case of mining and heavy industries capital was raised at the open market, otherwise shares were mostly sold to affiliates of employees of affiliates. “Open financing” was used by the non-zaibatsu firms, which were mostly engaged in railroads and textiles. Their stocks were bought on the open market by a limited number of wealthy investors. Due to a weak and undeveloped capital market the companies were forced to accept payment in instalments and use their stocks or other collateral to obtain bank loans. Non-zaibatsu companies also issued bonds, which were mainly bought by banks (Masaki, 1986, p. 294-301).

Although estimations of capital structures of companies in the pre-war period differ in their outcomes, they agree that stocks constituted the largest source of funds. The ratio of equity declined from about 82 to 66 percent between 1902 and 1940. Bond financing grew from about 9.5 to 17.5 percent and borrowings from banks were between 3.2 and 6.7 percent. Bank financing at that time was even less important than trade credit which was between 5.1 and 8.4 percent (Hoshi and Kashyap, 2001, p. 36-38).

Okazaki performed a study into the state of corporate governance in the 10 largest zaibatsu and the 10 largest non-zaibatsu firms in 1935. The majority of the large firms in mining and manufacturing (especially cotton and silk) were non-zaibatsu firms. In both groups shares were heavily concentrated into the hands of the ten largest shareholders. In the case of zaibatsu firms the ten largest shareholders held 65.9 percent of all shares, among which holding companies held 43.1 percent. For non-zaibatsu firms the ratios were 32.1 percent and 18.8 percent respectively. In zaibatsu firms there were hardly any cases of large shareholders becoming directors. Most of the directors were internally promoted, and some directors were dispatched from the holding companies. In non-zaibatsu firms more than 20 percent of the directors were among the largest shareholders. Therefore, the directors in non-zaibatsu firms monitored the execution of company business by the management from the shareholders’ viewpoint. In the case of the zaibatsu companies systematic monitoring was carried out by the holding companies (Okazaki, 1999, p. 102-106).

It is also interesting to note that in the pre-war period director’s bonuses were considerably higher and more closely related to profits than after World War 2. When compared with the non-zaibatsu firms, it is also clear that the zaibatsu firms paid higher bonuses. According to Okazaki that is because

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for 1937 23 and 24 and for 1946 50 and 53 per cent. The ratio of loans of the four great *Zaibatsu* banks to those of all ordinary banks increased from 44 per cent in 1937 to 66 per cent in 1945.”

decision-making in the zaibatsu firms was more decentralised than in the non-zaibatsu firms, and zaibatsu firms therefore relied more on an incentive system (Okazaki, 1999, p. 106-108).

The war with China started in 1937. The Temporary Funds Adjustment Act of September 1937 was the first step towards government control over the allocation of long-term funds. The government also limited dividend payments and thus made stocks less interesting for investors. Furthermore, the government sought to consolidate and strengthen the banks. As a result of a wave of mergers in April 1943 the four major zaibatsu banks (Teikoku Bank for Mitsui, Mitsubishi Bank for Mitsubishi, Sumitomo Bank for Sumitomo, and Yasuda Bank for, of course Yasuda) controlled about half the capital of all of Japan's financial institutions (Hoshi and Kashyap, 2001, p. 56-59).

The Company Accounts Control Directive in 1940, made dividends as well as directors' bonuses unrelated to profits. In 1943 the government issued the Munitions Corporation Law. Designated munitions corporations received financing from a designated financial institution. These banks' lending was covered by Wartime Finance Bank's guaranteed bonds. Any profits made by the munitions corporations were to be used as incentives for employees in order to increase productivity. From 1944 dividends were limited to 5 percent of the face value of the shares. The rights of stockholders to decide the disposal of profits, the appointment of directors or the floatation of bonds were terminated (Okazaki, 1999, p. 117-120).

Towards the end of the war the influence of the holding companies had thus been diminished. The position of workers had become stronger and relatively independent. Banks had gained in importance although monitoring by the banks was delegated to the Wartime Finance Bank. Until 1938, the CC required that directors had to be shareholders too. Board of director composition in 1942 showed a sharp drop in directors that were externally appointed or were large shareholders (Okazaki, 1999, p. 113-115). Directors that had been internally promoted increasingly dominated the board of directors. Dividend control under the "Corporate Profits, Dividends and Capital Accommodation Directive" of April 1939 was replaced by even tighter dividend control under the "Company Accounts Control Directive" of October 1940. Companies that were capitalised at a minimum of 200,000 yen, required ministerial approval for dividends higher than 8 percent, or exceeding the rate of the previous year (Okazaki, 1999, p. 111 and 114).

1945-1980

The American occupation authorities sought to break up the zaibatsu and reorganise the banking and monetary system. The Stock Exchange was not allowed to be reopened until there were legislation and a Securities and Exchange Committee (SEC) in place to secure democratisation of Japanese securities markets. Dismantling the zaibatsu met with lack of co-operation from the Japanese government. Only 30 of the 83 companies targeted for dissolution were effectively dissolved. The other companies on the list managed to escape except for their holding structure as holding companies were no longer allowed. The financial institutions of the zaibatsu also survived more or less intact (Hoshi

and Kashyap, 2001, p. 68).

The zaibatsu families and companies had to transfer their stocks to the Holding Company Liquidation Commission (HCLC) after which the Securities Co-ordinating Liquidation Committee (SCLC) sold the shares to the general public in a democratic manner. At the re-opening of the Tokyo Stock Exchange in 1949 it appeared that individuals held about 70 percent of listed stocks. According to Aoki, in many cases the very companies whose stock was being sold supplied the money to buy the stocks to the individuals. Many of these individuals were employees of the dismantled zaibatsu companies. The law did not allow holding companies or treasury stock, but it was not before long that these shares were again transferred to stockholders that had old zaibatsu connections (Aoki, 2000, p. 63).

The large company groups that emerged after the war are the vertical keiretsu modelled on the old zaibatsu, the horizontal keiretsu including some of the non-zaibatsu companies from before the war, and enterprise groups centred around very large enterprises. The six keiretsu are Mitsubishi, Mitsui, Sumitomo and Fuyo (all vertical), Sanwa, and Dai-ichi Kangyou (both centered around the banks after which they are named. Independent large enterprise groups include the Toyota group, Seibu group, Kyougin (the Industrial Bank of Japan) group, Shin Nittetsu group, Kintetsu group, and the Daiwa-Nomura group among others.[43]

Characteristic activities of the keiretsu are the monthly or weekly meetings of the presidents of the companies belonging to the keiretsu or the regular meetings at management level. The list of participants is public, the agenda of the meetings is not.

In a publication in 1976, Futatsugi (1976) mentions five characteristics of Japanese large companies and company groups as follows:

1. most shareholders are legal persons
2. cross-shareholding
3. increase of the number of companies under a keiretsu
4. exclusive transactions
5. dependency on bank borrowing and financing within the keiretsu
6. the inclusion of companies belonging to different industries within the keiretsu in order to limit competition (one-set-*shugi*)[44]

As we saw above, in 1949, individuals held about 70 percent of all shares. According to Futatsugi, financial institutions and legal persons held only 15.5 percent. By 1960 individual shareholding had decreased to 50 percent, and in 1973 financial institutions and legal persons held 61.7 percent (Futatsugi, 1976, p. 14-15). Mutual shareholding also seems to have served as a defence against hostile take-overs since 1952. When in the mid-1960s stockholding by foreigners was liberalised, the practice of cross-shareholding became even more entrenched (Aoki, 2000, p. 64).

Between 1960 and 1970 the number of affiliated companies and

[43] Sangyou Doukou Chousakai (1999), *Nihon no Kigyou Shuudan '99*. Used here is information from the *bekken* (=appendix). The *Nihon no Kigyou Shuudan* (=Japanese Company Groups) appears annually for all six of the keiretsu plus the appendix for the independent groups.

[44] *shugi* (主義) means: –ism.

subsidiaries of the largest one hundred corporations increased remarkably. Shareholdings of between 25 and 50 percent increased from 857 cases in 1960 to 3,063 cases in 1970. The number of cases with shareholdings of over 50 percent increased from 1,576 to 2,818. Stockholdings by the six large general trading companies occupied a total of 141 percent of the book-value of their own capital stock in 1966. This percentage increased to 301 in 1971, and 604 percent in 1973 (Futatsugi, 1976, p. 20-12). Certainly these numbers show an increase in the number of companies under the umbrella of a keiretsu, but on the other hand also simply represent an aspect of economic growth. A characteristic of business operations in large Japanese companies and especially within the keiretsu was the fact that a large part of the business transactions took place between companies within the keiretsu. Stable relations between transaction partners were highly valued.

After the war, banks were the first to be re-established. The Dodge Line had put and end to the deficit financing. Supported by the Bank of Japan, the banks stepped into the void left by the Reconstruction Finance Bank. The percentage of lending to large companies by the six largest city banks increased from 37.4 percent in 1950 to 52.4 percent in 1955. Among which lending to large companies by the Sanwa bank doubled from 21.6 percent to 43.9 percent over the same period (Suzuki, 1993, p. 20 and 58).

Central in the keiretsu are the banks and the general trading companies. The trading companies for playing an intermediary role and extending trade credits. Providing bank loans and monitoring were the main tasks of the banks. The main bank holds shares and bonds, lends, provides bill discount and other financial services, and as such is the nucleus of an enterprise group. One-set-*shugi* grew out of the motivation to limit competition within the group, very much like the zaibatsu had done before.

The role of the main bank in the governance structure of Japanese companies during the high growth period was in part a consequence of tight regulation of the securities markets in those days. Another important cause is a preference by the government for companies to raise capital by means of indirect financing via banks rather than direct financing through issuing bonds or shares (Hoshi and Kashyap, 2001, p. 93). As most city banks were dependent on borrowings from the Bank of Japan, the discount window provided a possibility to exert some influence on the banks' lending behaviour towards companies in industries most favoured by the government. The relatively high real tax rates may also have contributed to companies' bias towards debt financing.

Other banks than the main bank provided funds to the companies, but the monitoring function was delegated to the main bank.[45] The main bank was expected to ensure the expected rate of return. Its role involved ex-ante, interim and ex-post monitoring where the main bank remained passive in case a firm was performing well and repaying its debt. At the sight of trouble, the main bank

[45] Teranishi (1994) claims that monitoring by the main banks is the logical outcome of loan syndication practices. Japanese banks seem to have resorted to loan syndication in rescue attempts in the early 1930s (p. 66) and as a means to reduce risk through loan diversification under the wartime financial system in the late 1930s (p. 70).

will renegotiate the debt claims of the firm in distress, provide financial assistance and demand higher compensating balances. If deemed necessary the main bank could send its own employees to serve as managing directors to formulate and implement restructuring measures which could include a merger or tie-up with a healthy firm (Sheard, 1994, p. 194-204).

As main banks generally provided services to firms such as managing their settlement accounts, discounting their bills of exchange, and in case of foreign trade issuing their letters of credit or arranging foreign currency hedges, they were thought to be in a position to notice trouble at an early stage.

Under "contingent governance" as Aoki (2000, p. 71-72) calls this type of monitoring, it is understood in advance that the main bank will gain control in the event that a firm falls into financial distress. The bank will take responsibility and bear the costs for restructuring efforts or for the liquidation process. Under such a system it would be very costly for banks to shirk their monitoring responsibilities. Nakano explains the situation following a mechanism that transfers corporate control from shareholders (as residual claimants) to creditors (as preferential claimants) when a company falls into financial distress. He then translates the mechanism into a Japanese version transferring corporate control from the group of employees and management to the main bank (Nakano, 1996, p. 86-87).

It is generally assumed that business risk and financial risk were greatly reduced by the stable shareholding practise within the keiretsu and the inherent information sharing. Furthermore, there seems to have been a strong consensus that major companies should not be allowed to go bankrupt. This can be illustrated by the case of Yamaichi Securities' near failure in 1965. The Bank of Japan extended an emergency loan of JPY28 billion in order to avoid liquidation (Brown, 1999, p. 75).[46]

As the Japanese economy was growing, foreign exchange restrictions had been lifted, the internationalisation of financial markets continued, and companies were increasingly able to manage without the banks. Since 1970, Japan had been a net creditor nation. Japanese corporations invested overseas and were able raise capital overseas. Although the monitoring function of the main banks decreased in importance, there was no substitute readily available or deemed necessary by the company managers. Financial reporting and auditing standards had not kept pace with these developments, and still continued to protect creditors rather than investors in equity. From about 1973 convertible bonds became an immensely popular means of raising capital. They remained popular until the a few years after the collapse of the bubble economy when the market participants realised that the singularly upward trend of stock prices was history.

1980-1996

Particularly in the second half of the 1980s equity financing gained importance through conversion of the above mentioned bonds or direct share issues. Shares were increasingly issued at a premium rather than at face value. The

[46] In the aftermath of this crisis, regulation of the securities industry became stricter. The number of securities firms fell from 1127 in 1949 to 277 in 1968.

companies that started this practice were the independent companies such as Sony. Although the amendment to the Commercial Code in 1950 established rules for issuing non-par value shares, this had not been widely practised because it was surrounded by a negative image of unreliability and management incompetence (Sugino, 1998, p. 18).

Although the equity ratios in most companies' balance sheets came substantially closer to what was considered prudent in many other countries, stockholder influence in the annual shareholders meetings remained rather limited. Companies also increasingly financed their operations with retained earnings. The decline of monitoring by main banks created a corporate governance void. Banks owned relatively small percentages of a company's stock. The maximum allowed by law was 5 percent. Corporate managers were quick to fill up this governance vacuum as there were no new laws effectively strengthening the position of shareholders.

The period of stable growth and the bubble years enabled managers and companies to comfortably get away with less than excellent performance. As mentioned elsewhere in this chapter, many investment decisions were made with the purpose of increasing turnover and market share in mind. The cost of capital used as a cut-off rate was extremely low due to the methods of estimation applied. Hence in many cases investment decisions may have yielded the expected returns but did not maximise the value of the firm.

Banks had extended large loans against asset inflated collateral. When the bubble burst, many loans turned sour and eventually became uncollectible. However, the accounting standards at the time allowed the banks and other financial institutions too much room to decide on how to define bad loans. As a consequence of which many bad loans were not reported in the hope that the market would recover.

It is not only the banks and other financial institutions that are now ridden with bad debt. The practice of extending liberal trade credits goes all the way from the top down and vice versa, and any large failure could trigger a knock-on effect of which the consequences are incalculable.

1996-2003

The financial Big Bang as announced by prime minister Ryutaro Hashimoto in the winter of 1996 induced an even greater need for accounting standards that were at par with international accounting standards. The main elements of the accounting Big Bang are: marked-to-market accounting for securities and derivatives, making consolidated financial statements the main financial statements, tax collection on a consolidated basis, disclosure of pension liabilities and assets, and last but not least the introduction of consolidated cash-flow statements.

Ito (1999) describes possible consequences of the introduction of marked-to-market accounting for securities for Japanese management practices and corporate governance as follows. Traditionally the historical cost price was the basis for valuation of real estate and securities. Appreciation in the value of either was not reflected in the balance sheets, nevertheless the so-called "hidden assets" (*fukumi-shisan*) and hidden profits (*fukumi-eki*) were taken into

account as collateral by banks when extending loans. In the meantime corporate management excessively based their management decisions on the hidden assets.

Management based on hidden profits was rendered irrational when from March 2001 available-for-sale securities were to be valued at the current market price. Any valuation differences would result in profits or losses. Shares held for cross-shareholding purposes will also need to be marked to market. In this case the valuation difference will appear as a positive or negative component in shareholder's equity as an unrealised gain or loss. It will not directly have an impact on earnings, but it will influence return on equity, which is a factor that managers will have to take into account (Ito, 1999, p. 6-12).

When managers start to make investment decisions taking a more realistic cost of capital into account, the present returns on the capital invested in mutual shareholdings may prove to be destroying value. Thus it is expected that companies will dispose of a large part of their cross-shareholdings. However, in regard of present economic conditions and low stock-prices, massive cross-shareholding sales will only depress the stock market even further. Nevertheless, it seems that the trend has begun as companies are asking their business partners for permission to sell off their shares.

With interest rates approaching zero, and bad debt problems exacerbated by deflationary pressure, Japanese banks have found it increasingly difficult to provide loans. Many Japanese companies seem to have postponed investment until better times as much as possible. Capital is presently mainly raised through bond issuance because of the extremely bearish stock market. Notwithstanding the fact that this trend is causing equity to total capital ratios to go down again, most main banks are in dire straits themselves and are in no position to perform the role of monitor and lender of the last resort.

The most active investors on the capital and financial markets are probably mutual investment funds and pension funds. Although they hold large percentages of shares in various companies, these funds are usually not involved in very active monitoring as they hold diversified portfolios. On the other hand, pension funds have had a reputation for realising ridiculously low returns on their investments. With the strong pressure of an ageing population, they might want to become more involved in monitoring in order to improve on their own performance as well as the performance of the companies they are investing in.

Amendments to the Commercial Code in 2001 and 2002 are meant to strengthen the position of shareholders and statutory auditors, and to increase transparency of practices in the boardroom. Large corporations are given three choices. The first is to keep the governance system as it is. As a consequence of the amendment to the CC in 2001, the position of the statutory auditor has been strengthened. But other than that, nothing has to change. A second choice is to establish an "important property committee" within the existing governance structure. The task of this committee is to make decisions concerning the disposition or acquisition of important property, and issuing large amounts of debt. Establishment of such a committee is to be decided on by a board of directors with a minimum of ten members, the committee shall consist of at least

three members one of which is from outside the company. The statutory auditor will still be part of the governance structure.

A third option is to establish three committees to advise and aid the board of directors in making their decisions. The committees are: a designated committee *(shimei iinkai)*, an auditing committee (*kansa iinkai)*, and a compensation committee *(houshuu iinkai)*. In order to relieve the board of directors from some of its heavy responsibilities towards the shareholders, the designated committee decides on the contents of items presented to the annual shareholders meeting by the directors. In this structure the auditing committee will replace the statutory auditor. Third, the compensation committee decides on the remuneration of directors and executives (Ohta, 2002, p. 267-268).

In spite of the recent amendments to the Commercial Code, and all the publications on the importance and the mechanics of creating shareholder value, company value, and managing for economic profit, the future of corporate governance in Japanese corporations still remains somewhat unclear.

The mandatory increase in the number of external directors does not mean a necessary impulse of fresh opinions and more discussion, if an outside director comes from a subcontractor or another somehow related enterprise. If the outside directors still owe gratitude to the company president for being nominated, or simply if contradicting a more senior or experienced person is about the worst offence one could commit.

Nevertheless, the new legal provisions make it possible for progressive companies to apply a new governance structure that opens new possibilities.

As we have seen throughout this chapter, the concept that debt and equity represent two different corporate governance systems needs some qualification in the case of Japan. In the pre-war period, the government tried to contain shareholder influence and limit dividend payments in order to promote its own military objectives. In the post-war period, the same happened with the purpose of supporting its industrial policies. Shareholders had become docile. In addition, cross-shareholding practices and large shareholdings (maximum 5 percent for one bank) by banks blurred the distinction between shareholders and creditors. Unwinding mutual shareholdings seem to have started, but the process is slow. This is partly in order to prevent the stock market from going down even more.

Corporate governance practices in large companies are very much influenced by traditions, customs, and culturally defined behavioural aspects. In the case of Japan, hierarchy, a strong sense of obligation, and the practice that most members of the board of directors have been internally promoted have had two important effects. The first is that it is extremely hard to be critical of or even openly disagree with people higher up in the hierarchy or people whom one is obliged to. In good times this speeds up the decision making process, but in bad times independent inputs into the decision-making process serve to counter-balance moral hazard. Secondly, a board of directors consisting of people that have been trained and gained experience within the company only, may display characteristics of inbreeding. In the era of rapid economic growth this characteristic may have served companies well, because the directors knew the company inside out. Large companies have become extremely large and

complicated and may be served better if the inside people are balanced by people who know the market and the outside world well.

Recent amendments to the Commercial Code are one step in the direction of more independence and better balance in the board room. In this way the concept of corporate governance and accountability to the shareholders is expected to shift more to the shareholder concept that is generally found in common-law countries. As such the function of financial accounting will be able to develop further to mitigate the problem of information asymmetry.

Even in the pre-war period there was a dual corporate governance structure. Zaibatsu governance and non-zaibatsu governance were different. Presently the dual structure is more in terms of size. Large companies are increasingly dependent on market-based corporate governance where shareholder interests are recognised and protected. Small and medium-sized companies will continue to depend on bank loans and bank monitoring. Presently this relation is formalised in a plan to promote relationship banking for SMEs.

2.6. Functions of Financial Accounting Standards under different Paradigms

Paragraph 2.1. introduced the crises that caused the paradigms governing economic policy, regulations and economic activity. The subsequent paragraphs explained how these paradigms impacted the environmental factors of Japan's financial accounting system. Present paragraph will evaluate the functions of financial accounting standards under the four different paradigms.

1868-1945

Making Japan a modern industrial country involved first and foremost financing and promoting economic development through setting up national banks. "Bank Bookkeeping Methods" issued by the MOF in 1873 provided the First National Bank, which was also the first joint stock company in Japan, a coherent and consistent accounting system based on double-entry bookkeeping. Amendment of the National Bank Act in 1876 established limited liability of shareholders. Stock-owned companies became very popular, and the number of banks boomed. The Tokyo Stock Exchange opened in 1878. The Commercial Code (CC) was established in 1890 and amended in 1899 to distinguish bonds from stocks and to permit bearer bonds (Hoshi and Kashyap, 2001, p. 25-26). Art. 190-193 of the CC stipulated the first financial accounting regulations that applied to all companies.

Initially, the Meiji government aimed to be a strong central authority that actively furthered growth through industrial policy and the introduction of foreign technology (Ito, 1992, p. 19-20), and that relied on a capitalist, market-oriented economic system. Following the war with China (1894/95) the Business Operation Tax Law was promulgated and special purpose banks such as the Taiwan Bank and Chosen (Korea) Bank established for local development of the colonies. According to Okazaki and Okuno-Fujiwara (1999, p. 2-3), the market-based economic system started to change gradually into a command

economic system under bureaucratic control, in the 1920s, accelerating to a war-time economy in the 1930s.

For accounting regulations, this had the effect that between 1931 and 1942 many accounting standards for assets valuation, cost estimation, and accelerated depreciation were pronounced, and special taxation laws directly related to war incidents were established. Dividend restrictions were implemented in 1939 and 1940, and directors' bonuses were regulated. The Munitions Corporations Law of 1943 restricted the rights of shareholders and instituted a profit-sharing system for employees (Okazaki, 1999, p. 117-120).

In the seventy-two years since the MOF issued the "Bank Bookkeeping Methods", accounting standards served the *fukoku kyouhei* ideal in two different ways. Initially, it served the purpose of industrialisation through their functions of stewardship and accountability, and assisting the optimal allocation of savings to investment opportunities. After the war with China, an additional function of accounting standards was to help the government stimulate companies to develop Japan's colonies. From about 1931, accounting regulations served as a tool for building a war-economy through changing corporate governance and directing funds into war industries.

1945-1980

During the US occupation, the occupation authorities (GHQ) aimed to make Japan a democracy with a market-based economic system modelled after its own. To this end it dismantled the *zaibatsu*[47], sought to democratise corporate management, and demanded a Securities and Exchange Law (SEL), again modelled after its own, to be in place before it allowed the stock exchanges to reopen. The accounting and other provisions of the SEL sought to protect shareholder interests and existed side by side with the accounting rules of the Commercial Code (CC) and the tax laws.

According to Okazaki (1999) it was the Dodge Plan reforms that balanced the budget and made companies deal with over-employment and soft budgets. Employees yielded some of their power in order to avoid bankruptcies and getting laid off, and banks provided loans and monitoring. "So by the early 1950s, a pro-growth corporate governance structure had been formed, its major players being growth-oriented lifetime employees and a similarly growth-oriented financing body of investors centred round a main bank" (Okazaki, 1999, p. 138).

Consensus on the overall importance of economic growth, the main bank system, and a high degree of financial regulation made for a financial accounting environment that was accommodating to industrial policies and measures that stimulated investment and capital formation. Economic growth was attained without any significant reliance on foreign capital inflow (Teranishi, 1999, p. 99). On the other hand, this environment was less conducive to direct finance, public disclosure, and the protection of shareholder interests. Several revisions of the CC and SEL were carried out to unify both accounting systems, but the result was rather half-hearted as we will see in Chapters 3 and 4.

After the first oil shock (1973), fiscal deficits started to emerge and

[47] For disbandment of the zaibatsu see paragraph 2.5.

economic growth slowed down. Companies relied more on retained earnings, but investment slowed nevertheless. Already from the mid-1960 it was clear that the audit function had to be strengthened, and consolidated financial statements needed to be introduced, because companies were using subsidiaries for window-dressing their own financial statements. The “Working Rules for Performing Audits” had indeed been revised in 1965, but consolidated financial statements were finally introduced for large and listed companies under the SEL in 1978, albeit as additional information to the unconsolidated financial statements.

In the thirty-five years between 1945 and 1980, the function of financial accounting standards was to support the policies and governance structure that brought about impressive economic growth and development. These were the result of a national consensus on the importance of national and personal prosperity. Accounting standards served as a tool in scarce resource distribution through the main bank system, retaining funds inside the company and through promoting investment in productive capacity. Instrumental were the Special Measures Taxation Law, the definite settlement of accounts principle, and specific provisions (Okada, 1999, p. 147). The priority of creditor protection over shareholder protection was expressed in the priority of the CC over the SEL, in dividend restrictions, and low priority on transparency and accountability.

The introduction of consolidated financial statements, irrespective of their secondary status and extremely brief contents, marked a concrete step away from accounting serving industrial policies and the governance structure centred on main banks. It represents an acknowledgement of the increased importance of direct financing and shareholder interests, and a step towards a more market-based economic system.

1980-1996

In Japan, the first half of the 1980s were an era of deregulation of cross-border transactions and improved access to international capital markets (Teranishi, 1999, p. 115-119; Hoshi and Kashyap, 2001, p. 232-236). The second half marked the growth of the asset-inflated bubble economy that was punctured at the end of 1989 (Cargill, Hutchinson and Ito, 2000, p. 4). This was a time of little activity in the development of Japanese financial accounting standards and accounting institutions. Regulations could not or would not keep up with the development of new financial products such as derivative financial instruments or financial leases, which provided many opportunities for companies to manipulate accounting numbers. Hidden losses surfaced, such as the cases of Showa-Shell in 1993, Kajima Oil in 1994 (Ito, 1998, p. 36-39).

The *Heisei* recession brought to light the less than sound lending practices during and after the bubble period, and a related enormous bad loans problem. Initially, the government and all parties involved hoped for a soft landing (Cargill, Hutchinson and Ito, 2000, p. 4). It became clear that the monitoring function of the main banks had been hollowed out, and the monitoring function of the board of directors and the shareholders was not working properly (Wakasugi, 1999, p. 34-35). Existing accounting standards made it hard for the government to grasp the extent of the bad loan problem for

several years. When in 1996 the financial system was about to destabilise, swift structural change had finally become unavoidable.

Over the years between 1980 and 1996, financial accounting standards came to function in a corporate governance vacuum because the old paradigm had become obsolete without many people realising it. Because the regulations left so much room for arbitrariness it was prone to abuse.

1996-2003

The financial big bang was part of a plan for structural reform of Japan's government and regulatory institutions as well as for deregulation of its financial markets so they would be up to par with those of London and New York. Japan's financial markets were to become free, fair, and global. In order to make Japan's capital markets fair (transparent) and global, there followed an overhaul of the accounting system that was meant to bring the financial accounting and disclosure standards level with US-gaap and IFRS. An important aspect of accounting institutional reform was the shift from public regulatory authorities to a private standard setting body in 2002.

A second objective was to promote free, fair, and global corporate governance. Fair value accounting was intended to be instrumental in bringing an end to mutual shareholding practices. Amendments to the CC included changes to the regulations concerning the composition and functioning of the board of directors, aiming to increase the number of outside directors. Based on the above it is fair to say that the function of financial accounting standards today is to create and maintain a level playing field for Japanese companies in global markets.

2.7. Conclusions

Chapter 2 set out to answer the question how the Japanese accounting system has responded to a changing international business environment by identifying these changes and their implications for the functions of accounting standards and financial information. Foreign political and macro-economic policies dictated the role of accounting in Japan until political power and economic strength were no longer an issue. Globalisation of business and internationalisation of financial and capital markets brought the issue of comparability of financial statements to the forefront of academic and regulatory awareness. In the 1980s and early 1990s there were discussions about international harmonisation of accounting standards. Presently efforts are focused on convergence.

Japan's financial accounting system itself has come about in response to the economic and institutional challenges that followed Japan's opening up its borders. The government chose a legalistic approach over a professional approach to accounting and all other types of regulation because it suited better its purpose of government induced economic growth and development. A common law approach needs a democratic environment, and this was simply too remote from the Japanese path of cultural and economic development at the time. Equally important was the fact that the Japanese government was in a hurry.

Before Japan's imperialist phase started in earnest (1931), Japan's accounting system developed at a similar level and pace as was the case in Germany and the US. The Great Depression was in part the consequence of weak monitoring and corporate governance functions. Both Germany and Japan sought the solution to the economic depression in war. After World War II the US occupation tried to force American models and solutions onto Japanese problems. Although this seemed to work fairly well, the Japanese government kept what they found useful and discarded what did not suit their macro-economic policy purposes as soon as the occupation ended in 1952.

The corporate governance model that had emerged during the war had actually been reinforced by the GHQ's attempt to democratise the economy. Compartmentalisation of the financial system due to the SEL had fostered the main-bank system. Main bank financing and monitoring worked well during the high-growth era. Financial accounting did not play an important role in providing information for investment decisions by shareholders. Its main purpose was to compute distributable and taxable income.

The 1970s and 1980s were a period when accounting regulators in Japan could have kept pace with most developed countries or could have played a leading role, but chose not to. Although the signs of flaws in the corporate governance and reporting systems were already unmistakably there in the 1960s, regulators were too strongly influenced by business interests. The long-overdue introduction of consolidated financial statements, their secondary status, and weak audit requirements (especially under the Commercial Code) facilitated abuse at the expense of shareholders. Main banks' monitoring functions hollowed out and were filled by corporate directors giving rise to increased moral hazard.

Financial deregulation was slow and inadequate. Japanese companies enjoyed a freedom abroad that they did not at home in trying out new financial products such as options, futures, and unsecured bonds. Accounting standards for leases, options and futures were issued in pace with deregulation efforts at home when authorities realised that the sheer scale of off-balance sheet transactions was enormous and the business community was no longer able to stall their introduction.

Trade frictions, foreign demands for deregulation, increased disclosure and structural change yielded very few concrete results. In some cases the new regulations were formally pronounced but gave companies the option not to adopt the standard for a couple of years. For example the equity method took from 1978 to 1983 to become mandatory, and segment disclosure standards took nine years (1988 to 1997) to be fully implemented. Or in other cases the disclosure did not have to be audited by an independent auditor, which was the case with disclosures on options and futures, interim financial statements or with the unconsolidated cash-flow like statement.

The bad loan problem that appeared after the burst of the asset-inflated bubble economy of 1986 to 1989 was not effectively dealt with. In fact the government's forbearance in the hope of a soft landing actually contributed to the problem growing worse and taking on crisis-like proportions. As a consequence Japan's government bonds were downgraded, Japanese banks

had to pay a “Japan-premium”, and internationally faith in the Japanese economy and capital market fell drastically. Financial deregulation and the accounting big bang came about in response to these circumstances rather than in direct response to foreign pressures.

Lower quality accounting and disclosure standards would damage the position of Japanese companies in international financial and capital markets. Therefore, international comparability of the financial statements issued by Japan’s multinational corporations became a major objective for Japan’s accounting regulatory authorities just before the turn of the century. When the EU announced that it would demand companies issuing securities within the EU to prepare financial statements in accordance with IFRS or equivalent accounting standards starting in January 2007, the *keidanren* and the ASBJ were first complaining. But in January of 2005 they embarked with the IASB on a convergence project.

Having identified the international events that triggered the paradigms according to which the function of accounting standards in Japan changed, we have discussed how Japan’s economy, her financial system, taxation system, and corporate governance practices developed. Chapter 3 will analyse in detail how the characteristics and accounting concepts of Japan’s financial accounting system developed in response to the changes in these environmental factors.

Chapter 3: Japan's Financial Accounting System

3.0. Introduction

Chapter 2 presented a discussion of environmental factors that influenced the development of Japan's accounting system. We found that events in international relations defined as "political and economic ties with other countries" triggered a clear response in the first two periods. This response easily translates into the first two paradigms of "rich country, strong army", and "becoming a rich country" in the first and second period respectively. Internationalisation of business and financial markets has had a pervasive influence on Japan's economic growth and development, financial system, taxation system, and corporate governance practices in all four periods under discussion. However, the third and fourth periods show international market forces gradually overtaking international relations in terms of their influence on business and capital market transactions and the factors that shape Japan's accounting system. The third period was characterised by the lack of a clear paradigm, but in the fourth period the paradigm became "creating a level playing field" where the Japanese accounting and financial systems are supposed to be free, fair and global.

In order to answer the question how Japan's financial accounting system has responded to the changing international business environment, we will investigate what I consider the four main characteristics of Japan's accounting system. The first and the second, being the regulators and the regulations, make up Japan's financial accounting institutional framework. In addition the third and fourth, to be named creditor protection and the secondary status of consolidated financial statements, concern financial structure and corporate governance practices and indicate the nature of the role of accounting information. Furthermore, we will discuss the development of five of the accounting concepts and approaches that are instrumental in fulfilling the fundamental tasks of Japan's financial accounting system.

International accounting systems classification studies provide some

guidance for determining the most important characteristics of Japan's accounting system. Mueller (1967) pioneered a classification by distinguishing patterns according to which accounting systems developed, such as the macro-economic and micro-economic patterns. A second dimension of his analysis is a distinction between accounting as an independent discipline with room for judgement and estimate as opposed to the uniform accounting pattern where accounting is standardised and serves as a means of administration and control. The macro-economic and uniform accounting patterns apply to Japan and fit very nicely with the "rich country, strong army" and "rich country" paradigms of the first and second period under consideration.

Nobes (1983) extended this research and placed Japan in a category with Germany under the macro-uniform based classification, further specifying a law-based pattern rather than an economics-based pattern of development. Based on an expert survey in fifty countries, Doupnik and Salter (1993) produced results consistent with Nobes' findings. In addition they concluded that the macro-uniform and micro-based groups correspond with code-law and common law legal systems respectively. Furthermore, companies in countries in the macro-based group rely less on capital markets than those in the micro-based group. As we have seen in Chapter 2, until 1996 Japanese companies indeed relied more on bank loans and syndicated loans than on capital markets.

Empirical research carried out by Nair and Frank (1980) using 1975 data placed Japan's measurement practices in the conservative United States model, but disclosure practices were much harder to classify. In Chapter 2 we already encountered the study by Gray that translated Hofstede's cultural workplace values into cultural accounting values, according to which Japan's accounting system was characterised by statutory control and uniformity with regard to authority and enforcement.[48] In addition, Japan's measurement and disclosure practices were characterised by secrecy and conservatism.[49]

In both Radebaugh and Gray (1997, Chapter 3), and Choi, Frost and Meek (1999, Chapter 2), the legal system is mentioned as one of the environmental influences on accounting development. Legal systems are usually divided into common law and code law systems. The former is generally associated with a micro-economic pattern of accounting development the latter with a macro-economic approach. Whilst acknowledging the code-law legal system as an environmental factor in the development of Japan's accounting system, Chapter 3 discusses the actual regulatory authorities, laws and regulations as the institutions of the accounting system itself.

Ball, Kothari and Robin (2000) performed a study into the relation between corporate governance systems and timeliness and conservatism of accounting earnings. First, they looked at the extent to which current-period accounting income incorporates current-period economic income. Secondly, they addressed asymmetric conservatism by investigating the timeliness in incorporating negative economic income in accounting earnings. Their idea is that the stakeholder governance model prevalent in code law countries is

[48] As opposed to professional control and flexibility.
[49] As opposed to transparency and optimism. Gray, S.J. (1988).

associated with earnings as “income for distribution” among the stakeholders. Therefore, income should be stable over time. Timely disclosure does not play an equally important role because direct communication between managers and stakeholders solves information asymmetry problems (Ball, Kothari and Robin, 2000, p. 3). On the other hand, in common law countries the shareholder governance model is ubiquitous, and therefore timeliness and decision-usefulness are important properties of accounting information. Accounting income should then incorporate economic losses in a timely fashion so investors and shareholders can make their investment decisions.

According to Ball, Kothari and Robin (2000, p. 3), the stakeholder governance model implies a larger political influence on accounting standard setting. Indeed the discretionary choice of measurement and recognition standards in Japan was partly due to the political clout of businesses in the standard setting process (Someya, 1993, p. 95 and 102). An explanatory factor for the focus on creditor protection is that the Commercial Code, which is the basis of all accounting in Japan, adheres to the legal entity view. For similar reasons, the tardy introduction and the secondary status of and limited disclosure in consolidated financial statements were intended to stall the information and accountability towards shareholders and arms-length investors.

The authorities regulating Japan’s accounting and reporting system together with the actual standards, rules and regulations constitute the two major institutions in Japan’s accounting system. Perhaps the plural “Japan’s accounting systems” would be more accurate since the accounting system under the Commercial Code (CC) and that under the Securities and Exchange Law (SEL), serve distinctly different purposes and are governed by different ministries.[50] It is important to keep in mind that the CC applies to all companies, whereas the SEL applies only to publicly listed companies. Paragraphs 3.1.1. and 3.1.2. will elaborate on these peculiarities, and the inconsistencies between the two systems will appear where applicable throughout this chapter.

Turning back to the issue of institutional characteristics, Japan has generally been classified as a code law country with a legalistic approach to accounting regulation (Hiramatsu, 1994, p. 147-18). Public sector regulatory authorities set accounting standards until 2002, after which the privately funded Accounting Standards Board of Japan (ASBJ) took over. For a large part of Japan’s accounting history, financial accounting standards have been established with reference to macro-economic purposes and legal definitions of distributable income, rather than accountability or public disclosure and decision-usefulness of information for investors. Therefore, her public sector regulators and her triangular legal framework shall be analysed as the two main institutional characteristics of Japan’s financial accounting system.

As is common in code law countries, the Japanese accounting system stresses uniformity and the importance of form-over-substance. In other words, financial accounting information is presented in adherence to the words of the law, even in cases where this does injustice to the presentation of the underlying

[50] CC (administrated by the Ministry of Justice): creditor protection, calculating distributable income, providing income as the basis for taxation. SEL (administrated by the Ministry of Finance): shareholder and investor protection.

economic reality. Conservatism with regard to measurement and recognition of assets and liabilities in concurrence with the definite settlement of accounts in Japan is thought to serve creditor protection at the expense of shareholder interests (Hiramatsu, 1994, p. 150). A company viewed as a legal entity shall present its assets as potential collateral and shall value its assets objectively and conservatively (Takeda, 2003, p. 121).[51] Therefore, creditor protection is discussed in this chapter as a characteristic of Japan's accounting system that contributes to conservatism in measurement and recognition.

The importance of creditors over shareholders and other investors in Japan's financial accounting and disclosure system is a reflection as well as a cause of the same phenomenon in the corporate governance structures of many Japanese companies. Strong creditor protection measures and the secondary status of consolidated financial statements represent two characteristics of the Japanese accounting system that are intimately connected to the fact that in code law countries companies are viewed as legal entities rather than economic entities. Eventually the weak position of shareholders in Japan contributed to corporate governance failures because of insufficient disclosure, transparency and accountability. Under the SEL, the importance attached to consolidated financial statements has slowly increased over time, thereby reflecting a gradual increase of direct financing and a growth in the importance attached to shareholder rights.

Definitions of liabilities and equity, together with distribution of income concepts adhered to in an accounting system present clues to perceptions of ownership and corporate governance structures that may be prevalent within a country. Traditionally, the choice for presentation of clean surplus (all-inclusive concept of profits) or dirty surplus (current operating concept of profits) is closely connected to definitions of equity adhered to. The former comes with a narrow interpretation of equity which is related to the company as a legal entity concept, whereas the latter indicates a broader definition of equity which is connected to the company as an economic entity concept. Reconciliation of clean and dirty surplus through disclosure of comprehensive income serves to make company management's performance more transparent. Changes in the definitions of liabilities and equity and in distribution of income concepts shall be discussed because they may indicate shifts in corporate governance practices and the demand for disclosure of information.

Japanese disclosure practices have been labelled as characterised by secrecy instead of transparency (Hiramatsu, 1994, p. 147-148). One illustrative fact is that disclosure under the CC is less extensive than under the SEL, because its main purpose is the determination of distributable income.[52] Nevertheless the general shareholders' meeting is supposed to give its approval of the financial statements prepared in accordance with the CC. Only the

[51] On page 121 Takeda equates objective value with current or market value for the purpose of creditor protection. Bear in mind that he was writing about the state of affairs in accounting theory before the introduction of accrual accounting, the income statement approach to determining profits, and the realisation principle.

[52] For example, the CC has only recently introduced consolidated financial statements. Furthermore it does not require the disclosure of a cash flow statement.

financial statements of large companies have been independently audited. But when statutory and independent auditors agree that the statements have been prepared in accordance with the law (CC), approval by the general shareholders meeting is not required. Because the financial statements under the SEL are issued about a month later than those under the CC, shareholders have to wait in order to learn more about the company they have actually invested in.

Discrepancies between the CC and the SEL/BAP with regard to accounting and auditing took up much of the discussions, developments and attention between 1949 and 1981. The period between 1981 and 1996 represents a fairly barren age for accounting development in Japan, characterised by a sense of accomplishment and complacency in the beginning[53] and a sense of crisis towards the end. Since 1998 Japan's accounting system has modernised pervasively. Although the measurement and recognition systems are unified, the disclosure systems are still separate and different. Accounting and disclosure regimes under the CC and the SEL/BAP still make up Japan's accounting system side by side. True unification may be unattainable, and in many eyes perhaps even unnecessary or undesirable.

The remainder of this chapter is as follows. Paragraph 3.1. discusses the four characteristics of Japan's financial accounting system indicated above. Secondly, the accounting concepts related to the definitions of liabilities and equity, as well as the distribution and presentation of income are subject of consideration in section 3.2. Finally paragraph 3.3. brings together the environmental factors of Chapter 2 with the characteristics and concepts of Chapter 3 in order to answer the research question for section 1 of this dissertation.

3.1. Characteristics of the Japanese accounting system

Japan's financial reporting regulatory framework fits the code-law pattern because until 2002 it consisted of public regulatory authorities and its regulations took the form of legal requirements. Two other characteristics of Japan's financial accounting system: creditor protection and the primary status of unconsolidated financial statements, reflect the role of financial accounting information under prevalence of bank-centred financing and economic policies. Below follows an analysis of the development of these characteristics in response to the environmental factors that have been discussed in Chapter 2.

[53] Ibayashi wrote: "Thus in Japan there exist two disclosure systems. However, compared with the situation in the rest of the world these two systems are not considered backward. If anything, Japan belongs to the group spearheading the advanced countries, and one could say that except for a consolidated financial statements system, Japan is best equipped with a disclosure system." Ibayashi, Tsugio (1974) p. 59. It is possible to read the latter part of the sentence as: "Japan is best equipped with disclosure systems." When it comes to the number of disclosure systems this is probably true, but I doubt that he meant it ironically. Although I agree that in 1974, Japan's financial accounting system was not as far behind as it was in 1996, I do not consider lacking in a consolidated financial statements system a minor matter. In 1981 Japan did have a consolidated financial statements system in place. For differences in disclosure between Japan and the US from that time onwards, see Chapter 4.

3.1.1. Regulatory authorities

1868-1945

The institutions of the Tokugawa shogunate were aimed at maintaining the status quo with regard to power, and at the collection of taxes. Disputes were settled in a manner characterised by dependence on the wisdom of the local magistrates. The magistrates functioned within a centralised framework of feudal laws. Separate codes existed for Imperial Court nobles, *daimyo, samurai* and commoners (Hendry, 1989, p. 187).

After the Meiji Restoration new government institutions were founded, and the new Ministry of Justice established laws such as a Constitution, Commercial Code, Civil Code and Criminal Code in order to make Japan a modern though not primarily a democratic nation.[54] All of these were modelled on Western laws, mainly the German model. As a consequence of which the legal system turned out to be very much code-based. Within this code-based legal system the Commercial Code, which set and governed financial accounting standards, was established as well as administrated by the Ministry of Justice. It is therefore not surprising that, at least in peacetime, accounting standards were set by legal specialists rather than by accounting specialists.

Code law is associated with a public sector regulatory system and high political influence in the process of setting standards. The stakeholder governance model that is a consequence of such political influence places more importance on accounting standards as a means to compute income for distribution than as a vehicle to disclose information for investment purposes (Ball, Kothari and Robin, 2000, p. 3). A second role was the calculation of taxes. This was governed by the tax laws under the Ministry of Finance. Around 1941, the Japanese government found inspiration for its command economy in the communist laws and institutions through which the stakeholder governance model was strengthened, and the German war economy through which taxation became even more pronounced. Had accounting standards previously served macro-economic purposes, from around 1937 they served political and military purposes.

1945-1980

Democratisation of Japan's society was the primary aim of reforms carried out by the Occupation Authorities (GHQ). Such reforms included land reforms, labour reforms, and the dissolution of the *zaibatsu.* Before GHQ allowed the stock exchanges to re-open it demanded securities regulations and accounting and disclosure provisions after the US model to be in place so as to enable democratisation of financial markets. The Securities and Exchange Law (SEL) of 1948 made the compartmentalisation of financial institutions stronger than before the war. This coincided with the Japanese government's idea of financing industrial development with funds from special purpose banks.

A Securities and Exchange Committee (SEC) was supposed to

[54] The adoption of individual rather than family ownership was crucial to the limited liability system.

supervise securities transactions independently from the Ministry of Finance (MOF) (Kawamoto and Ohtake, 2002, p. 8-9). The Occupation Authorities left in April 1952, the SEC was reduced to an insignificant office under the name of Securities and Exchange Deliberation Council (SEDC) within the MOF in August 1952. The affairs of the SEDC were then to be carried out within the Securities Section[55] of the Financial Affairs Bureau[56] of the Ministry of Finance (Kawamoto and Ohtake, 2002, p. 9).

In 1964, a Securities Bureau[57] separated from the Financial Affairs Bureau, replacing the Securities Section. This elevated status within the Ministry of Finance followed a particularly unstable period in Japan's securities market. For example, Yamaichi Securities only avoided failure through a bailout by the Bank of Japan. The Securities Bureau severely tightened regulation of the securities industry (Brown, 1999, p. 75).

Accounting and disclosure regulations under the SEL consisted of the Business Accounting Principles[58] (BAP) the principles of which were incorporated into law by the Working Rules for Financial Statements[59] in 1949. The Business Accounting Deliberation Council (BADC)[60] had pronounced the above on July 9, 1949, to enable reopening of the stock exchange in 1949. The Financial Statement Regulations[61] (FSR) provided more detailed regulations after the BADC pronounced them in 1950.

Accounting standards under the SEL only applied to the financial accounting statements in the securities reports that listed and very large corporations had to submit to the MOF and the stock exchanges. These companies and all other companies had to submit their financial statements based on the Commercial Code (CC) to the companies' general shareholders meeting, the Ministry of Justice and then publish them in an official gazette. These statements were all unconsolidated and the net profits at the bottom line also formed the basis for taxation. In other words, the principle of the definite settlement of accounts means that unconsolidated net profits before taxation as submitted under the CC were the amount of profits that would be taxed under the tax laws. Therefore, the allowances, reserves, and accelerated depreciation measures under the Corporation Tax Law and the Special Measures Taxation Law made their way into the distributable earnings number.

The introduction of the Consolidated Financial Statement Regulations[62] in 1976 (effective as of 1978) only meant that consolidated financial statements had to be supplied as supplement to the securities report under the SEL within four months of the closing date of the accounting period. That was one month longer than for the unconsolidated financial statements under the SEL.

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[55] 証券課
[56] 理財局
[57] 証券局
[58] 企業会計原則
[59] 財務諸表準則
[60] Actually, it was its predecessor the Business Accounting System Measures Investigation Committee.
[61] 財務諸表等規則
[62] 連結財務諸表等規則

1980-1996

A Securities and Exchange Surveillance Commission[63] was established under the Ministry of Finance in July 1992 (Arai, 1999, p. 79-80). Established after a series of securities scandals in 1991, its purpose was to ensure investor's confidence in the fairness and increase transparency of securities transactions and the newly established futures market.[64]

1996-2003

As part of the institutional restructuring related to the financial big bang, June 1998 saw the establishment of the Financial Supervisory Agency[65] (FSA) absorbing the Securities and Exchange Deliberation Council. The Securities and Exchange Surveillance Commission was then placed under the FSA. At the same time, the Securities Bureau combined with the Banking Bureau forming the new Financial Planning Bureau[66] under the Ministry of Finance (Arai, 1999, p. 79-80).

From June until December 1998, the FSA resided directly under the Prime Minister's Office. Between December 1998 and January 2001 the FSA resided under the Financial Reconstruction Commission[67]. This commission had been called into a temporary existence to dispose of the bad loan problem and deal with ensuing bankruptcies. Currently, the FSA resides under the Cabinet Office together with the National Public Safety Commission and the Defense Agency.[68]

Also a temporary institution, the Financial Planning Bureau was replaced by the Financial System Stabilisation Division of the Finance Minister's Secretariat in July 2000. At the same time, the Japanese name for the Ministry of Finance changed from *okurasho* to *zaimusho* in order to better express the more limited role of the ministry. Furthermore, the Financial Supervisory Agency was renamed Financial Services Agency.[69]

The Business Accounting Deliberation Council[70] was one of the advisory councils to the FSA. The Business Accounting Council, as it is called in the English language version of the FSA homepage, "establishes business accounting standards and audit standards, and at the same time conducts investigations and deliberations concerning the unification of cost accounting and the development and improvement of other aspects of the business accounting system, and reports the results to the Commissioner of the FSA and others."[71] Before the reorganisation of the financial system, the Business Accounting Deliberation Council was an advisory organ to the Ministry of

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[63] 証券取引等監視委員会

[64] http://www.fsa.go.jp/sesc/aboutsesc/pamphlet/p3.pdf

[65] 金融監督庁

[66] 金融企画局

[67] 金融再生委員会

[68] See the FSA homepage at http://www.fsa.go.jp/indexe.html.

[69] 金融庁 For organisational charts see the FSA homepage at http://www.fsa.go.jp/indexe.html.

[70] 企業会計審議会

[71] http://www.fsa.go.jp/indexe.html, click "councils".

Finance.

On July 26, 2001 the Financial Accounting Standards Foundation (FASF) "was established in order to contribute to the sound development of financial practices in Japan and sound capital markets by making recommendations and contributions to the international accounting system (…).[72] The organisation consists of a board of directors, trustees, the Accounting Standards Board of Japan (ASBJ), and a theme advisory council. The idea was that the ASBJ would replace the BADC in its role of establishing financial accounting standards. More in line with the new financial system, financial accounting standards were to be established by a private sector organisation rather than by a government institution. Upon completion of its final project in 2002 (Opinion on Accounting Standards for the Impairment of Assets), the BADC has been dissolved, and the road opened for the ASBJ to function as a private organ to set accounting standards.

The private sector organisations responsible for establishing the FASF include: Keidanren, JICPA, Tokyo Stock Exchanges, Japan Securities Dealers Association, Japanese Bankers Association, The Life Insurance Association of Japan, The Marine & Fire Insurance Association of Japan, Inc., The Chamber of Commerce & Industry, The Securities Analysts Association of Japan, and the Corporation Finance Research Institute. Sometimes dubbed the Japanese version of the FASB, the ASBJ consists of the International Issues standing Committee (six working groups), the Practical Solutions Standing Committee (one working group), and seven technical committees.[73]

In 2001 the responsibilities of the Securities and Exchange Surveillance Commission were greatly increased. They now also include overseeing and strengthening the quality of financial disclosure as well as of independent auditing, carrying out criminal investigations into misleading financial information in securities reports and insider trading (Yamaji, 2005, p. 85-86).

Summarising the above, we find that accounting regulatory authorities in Japan as a code-law country were indeed located in the public sector. Only recently the overhaul of Japan's financial and accounting system led to the establishment of the private sector Accounting Standards Board of Japan (ASBJ). The ASBJ is responsible for accounting standards insofar as they are not a part of the Commercial Code (CC), because the CC can only be amended by the Diet. After an absence since 1952, there presently is an organ responsible for ensuring the fairness of securities transactions and the quality of financial disclosure that resides under the FSA but is separate from the MOF. Although Japan's accounting regulatory institutions have been transferred to the private sector, they stay firmly entrenched within the code-law legal system.

[72] http://www.asb.or.jp/e_fasf/outline.html
[73] See ASBJ homepage http://www.asb.or.jp/e.html

3.1.2. Laws, standards, rules and regulations

1868-1945

The CC (1890) and the Income Tax Law (1886, but revised in 1899) formed initially the legal accounting framework. The Business Operation Tax Law (1896) was added, and in 1926 replaced by the Business Operation Income Tax Law, which in turn was replaced by the Corporation Tax Law of 1940.

Because of strong opposition to the 1890 CC, the Diet decided to postpone its enforcement in 1892. However, the parts concerning companies, bills and bankruptcy were in effect as of January 1, 1893. The new CC went into effect as of June 15, 1899 (Fujita, 1991, p. 43-44). The 1899 CC's Art.190 required the board of directors to present an inventory, balance sheet, operations report, profit and loss statement, and a proposal pertaining to the division of the legal reserve, profits, and interest to the statutory auditors one week before the general shareholders meeting.

The above mentioned documents plus the statutory auditor's report were to be available at the company's head-office before the general shareholders meeting (Art.191). At the general shareholders meeting, the directors had to provide the shareholders with the above documents and obtain the shareholders' approval, upon which the directors shall make the balance sheet public (Art.192). The shareholders meeting's approval shall release the directors and the statutory auditors of their responsibility (Art.193). 1899 CC Art. 194 stipulated the retention of a legal reserve, and Art.195 prohibited dividend payments after the legal reserve had been used for the recovery of losses. Measurement rules were set forth in Art.26.

In 1899 income of legal persons was taxed at 2.5 percent, but after the introduction of the Corporation Income Tax Law in 1940 corporate income was taxed at 18 percent. Had the Income Tax Law in 1899 defined taxable income as 'total benefits minus total money losses', in 1940 the Corporation Tax Law expanded the definition by stating that total benefits are the increase in a company's net assets except for paid-in capital, and money losses are any decreases in net assets except for paid-in capital (Inoue, 1997, p. 14-16).

As of 1934, the Working Rules for Financial Statements provided the detailed guidelines that had been missing. From 1937 the Special Measures Taxation Laws helped to pay the bills for investment in buildings, machinery and ships by allowing one third of the purchase price to be written off immediately (Inoue, 1997, p. 17). The Working Rules for the Estimation of Manufacturing Prices (1937) and the Cost Estimation Standards[74] of 1942 were only replaced by the Cost Estimation Standards[75] of 1962. Later into the war the whole system was set up to favour the munitions industry.

1945-1980

[74] 原価計算規則
[75] 原価計算基準

After World War II, the Commercial Code(CC), the Corporation Income Tax Law plus the Special Measures Taxation Laws, and the Securities and Exchange Law (SEL) constituted the three legs of the triangular system that forms the legal framework for Japan's accounting standards. In 1948, the two legs that existed prior to the war were complemented by the SEL, which only applied to listed corporations and was influenced by American common law rather than Japanese code law. Financial statements prepared under the SEL will have to be in accordance with the Business Accounting Principles (BAP).The tax laws and the SEL are administered by the National Tax Bureau and the Securities Bureau respectively within the Ministry of Finance (MOF), and the CC is under the jurisdiction of the Civil Bureau of the Ministry of Justice (MOJ).

Taxable income is to be computed using accounting profits based on the Commercial Code. This so-called *kakutei kessan* principle is derived from the German Massgeblichkeit principle. The German principle means that accounting earnings should be the "measure" for the computation of taxable income. In Japan, the principle has been translated as *kakutei kessan* or definite settlement of accounts. In other words, taxable income is computed based upon net income resulting from the settlement of accounts as has been made final by the general shareholders meeting under the regulations of the CC (Corporation Tax Law Art.74) (Inoue, 1997, p. 41).

Under the definite settlement of accounts, tax laws influence accounting earnings as follows. In many cases assets are depreciated faster under the tax laws than the assets' economically useful lives warrant. This causes a problem that is called "reverse standard", meaning that in reality taxable income becomes the measure for accounting income (Arai, 1999, p. 71-72). In cases where the Special Measures Taxation Law applies these differences could be considerable, especially during the high growth period when industrial policy and financial policy were aimed at capital formation, export promotion, and the development of new products (Inoue, 1997, p. 60-61).

Upon recommendation by the Shoup Report in 1949, the Corporation Income Tax was amended in 1950. Share premiums, profits from capital reduction, and surplus from merger were no longer included in taxable income (Arai, 1999, p. 216). The Shoup Report had recommended that fixed assets be revaluated in relation to the extreme inflation in the early post-war period. Revaluation of fixed assets was allowed in three rounds in 1949, 1951 and 1953, but initially many companies chose not to participate. A possible reason could be that an increase in net assets due to revaluation was to be taxed at 6 percent (Kaneko, 1953).[76] Corporate income was to be taxed at 35 percent and income from securities was taxed at 25 percent. Amendment of the rules for the depreciation of fixed assets had to be carried out because initially the Corporation Tax Law did not allow increases in depreciation charges due to fixed asset revaluation.

[76] This article by Saichiro Kaneko, a member of the Ministry of Finance Asset Revaluation Deliberation Council, seems to be aimed at educating the readers of *Kigyoukaikei (Business Accounting)* on how revaluation of fixed tangible assets will prevent a hollowing out of companies' capital stock, and at convincing them that the 6 percent taxation of the holding gains will soon be offset by the larger depreciation charges.

Accounting under the SEL started with the pronouncement of the BAP and the Working Rules for Financial Statements in 1949, the Financial Statement Regulations and the Audit Standards in 1950, and the Annotations to the BAP in 1954. Art. 24 of the 1949 SEL requires companies to submit their financial statements and other information within three months of the closing of the business year to the MOF. According to Art.193, these financial statements have to be prepared in accordance with the Financial Statement Regulations (FSR) and be audited by an independent auditor or audit firm (Art.193-2). The MOF established the Financial Statement Regulations following principles that are generally recognised as fair and proper (Art.193). This phrase means that the BAP, which are supposed to be selected from fair accounting practice, form the basis for the FSR.

As the SEL applies only to a limited number of companies[77], initially its influence on the financial accounting system as a whole was fairly insignificant. The distinction between capital surplus and earned surplus was adopted by the CC in 1950. Accrual accounting was only fully adopted by the CC in 1962. Accounting under the SEL adopted the proprietary concept of income distribution and the all-inclusive concept of profits in 1974 for the purpose of adjustment to the CC. (See section 3.2.3.) Presentation of an inventory was then no longer required.

Since 1962 the general opinion was that the CC prevailed over the BAP because the CC did have legal authority and the BAP did not. On March 30, 1963, the MOJ issued the "Regulations Regarding the Balance Sheet and Profit and Loss Statement of Joint Stock Companies" (CC Statements Regulations)[78] in order to formally establish legal superiority of CC accounting, and in the meantime make the BAP redundant for unlisted companies. Because in practice the BAP played second fiddle to the CC, it is not surprising that the MOF was more preoccupied with the tax laws, their effect on the nation's coffers, on the national accounts, and on industrial policy, than with transparency and protecting shareholder interests.

In the 1960s it became clear that window dressing of financial statements and moving losses to unconsolidated subsidiaries were a problem under both the CC and SEL accounting systems. This caused the BADC to revise the Working Rules for Performing Audits[79] in 1965, and the Audit Standards[80] and the Working Rules for Audit Reports[81] in 1966. So the audit function was strengthened under the SEL, but it took until 1974 for the CC to introduce independent audits in addition to the already existing audits by a

[77] These are listed companies, companies that issue securities reports, companies with more than five-hundred shareholders, and companies registered as head-office. Although the number of listed companies is around 2000, the total number of joint stock corporations in 1995 was 1.123.034. The number of companies with a capital stock of over 500 million yen being around 5000, and companies with a capital stock of over 100 million yen being around 13.000, whereas the total number of companies was a little over 2 million. Many of the smaller companies depend on bank loans for a large part of their financing.

[78] 株式会社の貸借対照表、損益計算書に関する規則 or in short 計算書類規則

[79] 監査実施準則

[80] 監査基準

[81] 監査報告準則

company's statutory auditor. The "Law concerning the exceptions to the Commercial Code regarding the audit of *kabushiki kaisha"* (CC *tokurei*) constituted the audit system for large and small joint stock companies under the CC.

Chapter 2 of the CC *tokurei* applies to companies with a capital stock of over 500 million yen. Art.2 requires that these large joint stock companies be audited by an external auditor (*kaikei kansanin*), being a CPA or accounting firm. Chapter 3 regulates the audit function for companies with a capital stock of less than JPY 100 million. Small-size companies only need an audit of the accounts by the statutory auditor(s).[82] Medium-size stock companies, with a capital stock of between JPY 100 million and JPY 500 million, are apparently the only ones that are no exception under the CC.

Medium-size joint stock company audit requirements under the CC include only audits by statutory internal auditors (*kansayaku*). These audits consist of an audit of the accounts (CC: Art. 281-4) and an audit of operations. (CC: Art.274) Auditing for medium-size stock companies is regulated by the audit provisions in the CC. As described above, Art. 273 to 280 stipulate the rules for statutory auditors, and Art. 281-283 lay out the regulations for the procedures of submitting the financial statements to the statutory auditors, and getting the approval of the general shareholders' meeting.

In order to effectively unify the CC and SEL auditing systems it was necessary to unify the accounting standards of the two accounting systems. Until the introduction of requirements for external audits under the CC in 1974, the inconsistencies between the CC and the BAP/SEL had been practically inconvenient as well as discomforting from a legal and theoretical perspective for as long as twenty-five years. A sudden "solution" to this problem was found in a newly established a blanket clause saying: "One must consider fair accounting customs for the interpretation of regulations concerning the preparation of commercial accounting books." (1974 CC Art. 32-2)

In the September 1973 issue of *Kigyou Kaikei* (Business Accounting) a special was dedicated to the question of what fair accounting customs are. Takamatsu (1973, p. 41) wrote: "Although the Business Accounting Principles do not in themselves constitute the 'fair accounting customs' that the Commercial Code speaks of, at least one could think that the (fair accounting customs) include the (Business Accounting Principles)." About a year later Osumi (1974, p. 17 and 19) stated that with regard to business accounting, the CC demands that what is legal whereas the BAP demand what is just. Among corporate managers many declared that 'lawful' is sufficient and 'just' is not legally required. Many external auditors agreed.

Finally in 1978, the SEL introduced consolidated financial statements. The Consolidated Financial Statement Regulations[83] apply only to the relatively few listed companies. Furthermore, the disclosure requirements for consolidated financial statements were much less extensive than for unconsolidated financial statements. For a discussion of the difference between unconsolidated and

[82] Law concerning the exceptions to the Commercial Code regarding the audit of *kabushiki kaisha*, Art.22

[83] 連結財務諸表等規則

consolidated disclosure requirements see Chapter 5.

1980-1996

During this period several amendments to the CC, BAP, SEL and tax laws took place. The 1981 amendment to the CC included the establishment of Art. 16 of the CC *tokurei*. It purports that if the statutory and external auditors of large companies agree that the financial statements were in accordance with the law, directors do not need the annual shareholders meeting's approval of the financial statements. Approval is still required for the appropriation of earnings.

According to Kawamoto *et al*. (2002, p. 48), it was considered inappropriate to expect shareholders of large corporations to study the accounts extensively as the inspection of certain items in the accounts requires specialist and technical knowledge. On the other hand, Wakasugi (1999, p. 69) explains Art. 16 as a measure to strip the general shareholders meeting of its contents. In addition to capital stock of over 500 million yen, also companies with total liabilities of over 20 billion were included in the definition of large companies (CC *tokurei* Art. 1).

As part of a movement toward improvement of disclosure, the BADC issued an Opinion on the Disclosure of Segmental Information in 1988 at the codification of which segmental disclosure was stepwise required in consolidated financial statements between 1994 and 1997. The BADC Opinion on Accounting Standards for Futures and Options Transactions in 1990 followed the introduction of "futures on long-term government bonds in 1985, stock index futures in 1988, and stock options in 1989" (Teranishi, 1999, p. 112). However, this information was supplementary in nature and not subject to an independent audit (Sakurai, 2001, p. 1771). An Opinion on Accounting Standards for Lease Transactions followed in June 1993, and became effective under the SEL as of April 1, 1994. Although opinions and standards issued by the BADC are generally recognised as fair and proper business accounting standards, they do not have any legal status unless they are codified by the MOF (Takeda, 2003, p. 35).

1996-2003

The structural reforms that were announced in November 1996 did liberalise the financial system between 1998 and 2001. And in the tree years between 1997 and 1999, there was an explosion in volume and quality of accounting standards that was unparalleled in the fifty years since the establishment of the BAP (Takeda, 2003, p. 131). Structural reform removed the power of the MOF from the standard setting process, and the accounting big bang made the accounting system more transparent.

It also established the ASBJ as a private sector regulator in lieu of the BADC as a public sector regulator in July 2001. As we have seen above, accounting standards pronounced by the BADC had to be made into legally enforceable standards through MOF and later Cabinet office authorisation. This is not the case for the standards set by the ASBJ.

Even accounting standard setting under the CC underwent some transformation. Because the CC is a law, it can only be amended by the Diet. In

the 1990s business, financial and accounting developments followed each other up too quickly and the necessary knowledge became too specific for the lengthy process of pushing an amendment through the Diet. As of April 1, 2003 accounting standards, except the ones that are important for creditor protection such as the legal reserve and the calculation of distributable earnings, under the CC can be amended through Ministry of Justice ordinance.

In 2002 the CC was amended so that the valuation standards in Art.32 to 34 and Art. 285-2. 285-4, 285-5, 285-6 and 285-7, and the standards regarding deferred assets as in Art. 286, 287, and 287-2 could be moved to the "Regulations Pertaining to the Implementation of the Commercial Code"[84]. Effective as of April 1, 2003, these regulations prescribe the methods for valuation of assets and other accounting matters with regard to the calculation of profits. The accounting regulations that stay in the CC are Art.288, 288-2, 289, 293-3 regarding legal reserves, and Art.290-1 to 290-3 regarding the calculation of maximum distributable earnings (Takeda, 2003, p. 138-142).

The new and improved Commercial Code since 2004 requires large joint stock companies to issue consolidated financial statements (CC *tokurei* Art. 19 No. 2). However large companies that do not need to file their securities report under SEL Art. 24-1 are for now exempt from the obligation to prepare consolidated financial statements under the Commercial Code (Ohta, 2002, p. 294).[85] The contents of the consolidated balance sheet, profit and loss statement, and statement of retained earnings are to be prepared according to the "Regulations Pertaining to the Implementation of the Commercial Code" Ministry of Justice Ordinance No. 22. Consolidated supporting schedules or consolidated cash-flow statements are not required (Ohta, 2002, p. 294).

With the BADC Opinion on tax effect accounting for listed companies (June 1998, effective as of March 2000) and the introduction of taxation on a consolidated basis (fiscal years starting April 1, 2002) a truly new era started. Listed companies can choose to apply for consolidated taxation. Consolidated taxation can only apply to 100 percent owned subsidiaries (Watanabe, 2002, p. 23-25).

In 2000, the definite settlement of accounts principle was partly abandoned and as a consequence the triangular system has now only two and a half legs. It may take some time for the situation to change for small and medium-sized companies. In Japan the purposes of the three laws have generally been regarded as ultimately different. For the tax laws fair and equal taxation is the theoretical aim. From that perspective, it is surprising that the definite settlement of accounts system was maintained for so long. Throughout the high-growth period and until the early 1980s it may have served economic policy aims. Only the need to rapidly write off bad debt that was the consequence of the collapse of the asset-inflated bubble finally convinced all parties involved that tax effect accounting was necessary and beneficial. Providing investors with better insight in companies' economic reality has never been a convincing enough argument.

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[84] 商法実行規則

[85] The words "for now" (*toubun no aida*) were also used when accepting consolidated financial statements under US-GAAP, but that rule turned out not to be temporary.

According to Takeda (2003, p. 19-20), the purpose of the CC is to protect creditors and to calculate disposable income, and that of the SEL is to protect investors by providing information that is useful for making investment decisions. To the casually observing outsider it may make little sense to maintain two separate accounting systems whose aims are not that far apart and that could be serviced by one accounting system as is the case in many other countries. The SEL was forced upon Japan in 1948 by the American occupation authorities, and the BAP were issued hurriedly to make it in time for the re-opening of the stock markets. Both the SEL and the BAP were as alien to Japan as democracy or sit-down toilets at the time of introduction. Once introduced, all were transformed to bear distinct Japanese characteristics, but they were there to stay. Initially, for the Ministry of Finance, the SEL and the BAP represented newly acquired turf as well as an additional means to shape capital and financial markets and further macro-economic objectives.

Only when one considers the fact that the SEL applies to a little more than 2000 companies that produce about 70 percent of Japan's GDP, but the CC applies to a thousand times as many companies that employ about 70 percent of the population, the scale of things starts to fall into some kind of perspective. High leverage ratios and the stakeholder corporate governance model contributed to the relative unimportance of the SEL/BAP accounting system in comparison to the CC accounting system. Internationalisation of business, financial and capital markets in addition to the imminent instability of the financial system in the second half of the 1990s finally made it clear that accounting standards should be established by accounting specialists rather than by legal specialists.

Unity between accounting under the Commercial Code and the Securities and Exchange Law has been a topic of debate as well as a purpose of amendments in both laws during the past fifty years. Currently, the ASBJ sets the accounting standards for the listed companies that have to present their financial statements to the FSA and the stock exchanges that they are listed at. These standards have to be incorporated into the CC and the "Regulations Pertaining to the Implementation of the Commercial Code" because the accounting numbers have to be the same under both the CC and SEL accounting systems. And as we know, all companies have to prepare financial statements under the CC, have them audited, and present them to their general shareholders meeting. It is therefore fair to say that the highest ever degree of unity between the two accounting systems has been reached. Nevertheless, the SEL still does not apply to all joint stock companies, the CC only requires consolidated financial statements from the companies that already have to prepare them under the SEL, and external audit requirements do mainly apply to large listed corporations.

In sum, the triangular system of tax laws, CC, and BAP/SEL breaks apart into tax laws and CC for all firms, and BAP/SEL for listed firms. Financial statements under the CC are presented to the general shareholders meeting. Only those CC statements of the large listed companies are subject to independent audits since 1974. Since April 1, 2004 the companies that issue consolidated financial statements under the SEL have to do so under the CC as

well. Financial statements under the SEL are issued for general investors, have been independently audited since 1948, and are submitted to the stock exchanges where a company is listed and to the MOF (after the Big Bang to the FSA).

Because of the definite settlement of accounts principle, the tax deductions permitted under the Corporation Income Tax Law and Special Measures Taxation Law encouraged companies to minimise taxable income. Shareholders therefore had to make do with financial statements that were not prepared for presenting a company's economic reality. Naturally, income numbers under the CC and SEL were not supposed to be different, so investors and future shareholders were faced with the same problem. Since the introduction of tax effect accounting in 2000, an important institutional barrier for financial accounting information to be decision-useful and to faithfully represent economic reality has been removed. It remains to be seen how the new accounting standards issued by the ASBJ will interact with the BAP and the CC.

3.1.3. Creditor and shareholder protection

Adjustment of creditor and shareholder interests as expressed by accounting standards centres on the recognition of deferred charges and provisions or allowances. Deferred charges such as bond issue costs are listed as assets and amortised based on the logic that they contribute to the earnings process (Schroeder, Clark and Cathey, 2001, p. 313-314). On the other hand, creditors think of deferred charges as assets that do not represent any value as collateral in case of default or liquidation. Creditors care about retaining funds inside the company for liquidity and solvency purposes. Establishing reserves, provisions and allowances for purposes such as doubtful accounts, retirement benefits, price-level fluctuations, or simply for profit retention serve the aim of capital maintenance (Okada, 1999, p. 124-129).

Statutory legal reserves are established for the purposes of creditor protection and capital maintenance. Capital maintenance refers to the statutory requirement to retain net assets equal to the non-distributable reserves within the company (Elliott and Elliott, 1996, p. 393). Generally, reserves are divided into non-distributable reserves and distributable reserves. Due to inconsistencies between the CC and the SEL, Japan has been the scene of a debate regarding what reserves should be considered distributable and in what order distributable reserves could be used up, for most of the post-war period. From the very start in 1899, the CC established explicit dividend restrictions. With regard to corporate governance, the CC formally establishes the rights and obligations of shareholders, the board of directors, statutory and external auditors. In addition, there is the audit system under the SEL.

Creditors need to be protected against undue and unlawful distributions of a company's wealth to its shareholders. To creditors it is very important that there are restrictions on the distribution of profits and retained earnings. Secondly, creditors need to know the value of a company's assets as collateral.

On the other hand, shareholders are merely residual beneficiaries of the company. Shareholders are protected by their limited liability and the possibility

to sell their stock and salvage their initial investment. Of the highest importance to them are dividend payments and timely high quality disclosure of financial and other information from the company so they can make optimal investment decisions. Accounting standards regulating legal reserves are primarily a function of the relative importance of bank financing in a financial system and the political clout that creditors have in the regulatory process.

1868-1945

The 1899 CC allowed dividend payments only after the retention of at least one twentieth of total profits into the legal reserve (1899 CC Art. 194). In 1899 the legal reserve was made up of these profit retentions and share premium. Periodical profit retention into the legal reserve had to take place until it amounted to one fourth of total capital stock. Share premium was treated as profits by both the CC and the tax laws. When the legal reserve was being used for recovery of losses, which was the only purpose legal reserves could be used for, dividend payments were not allowed (1899 CC Art. 195).

Although dividend payments became more and more restricted in the late 1930s, this was motivated by a shift toward the stakeholder corporate governance model rather than purely for the purpose of creditor protection. The asset-liability approach to the determination of profits, and the preparation of an inventory were additional means for creditor protection, as these help creditors estimate the value of assets for collateral.

Between 1921 and 1936, in the years before the second war with China started in 1937, companies paid out sometimes as much as 70 percent of their profits as dividends. In this period dividends greatly exceeded capital increases whereas capital increases exceeded dividends between 1937 and 1943 (Okazaki, 1999, p. 108). In many companies the board of directors was increasingly made up of internally promoted directors rather than directors who were also large shareholders. In addition, the main bank system had spontaneously developed between 1939 and 1941 in the form of loan consortia, and was formalised and placed under the National Finance Control Association in 1942 (Teranishi, 1999, p. 74-78). Thus governance structures shifted in favour of creditor protection.

Under the 1899 CC the financial statements were to be audited by the statutory auditor and to be presented to the general shareholders meeting together with the statutory auditor’s opinion (1899 CC Art. 183). Both the statutory auditors and the board of directors were chosen by the general shareholders meeting, who also decided on their remuneration (1899 CC Art. 179 and 189). The statutory auditor was chosen for a period of one year, after which he could be re-elected (1899 CC Art. 180). In 1938 this period was changed to two years.

1945-1980

In 1949 the BAP adopted the stance that capital surplus and earned surplus[86] should be kept separate in order to prevent capital stock to be hollowed out by dividend or tax payments. With the introduction of this new concept, possibly the most debated of discrepancies between the BAP and CC was born. Hitherto reserves under the CC had simply consisted of non-distributable legal reserves and distributable voluntary reserves.[87] Through the 1950 amendment to the CC, the legal reserve came to be made up of a capital reserve and a profit reserve.[88]

Statutory retained earnings formed the source for the profit reserve. Amendment to the CC in 1962 increased the contribution to the statutory profit reserve from one twentieth of cash dividends to one tenth. (1962 CC Art. 288) Five items were established in 1950 as sources for the capital reserve: share premium, paid-in surplus over non-par shares[89], asset revaluation profit[90], profit from capital reduction, and profit from merger. At the time, asset revaluation profits (holding gains) were fiercely debated because scholars with a more legal orientation did not think that holding gains possess the nature of "capital" in the way that the other four items do, and should therefore be treated as profits, i.e. be subject to taxation and be distributable. The questions what items of capital surplus should be distributable and in what order capital surplus can be used up for different purposes, if at all, represented another source for vehement and lengthy discourse between legal and accounting scholars. Again, those who were the then more modern accounting scholars took the stance that most of the capital surplus should not be distributable (Sugino, 1998, p. 22).

Profit reserves were considered distributable as they consisted of retained income. The order of sources for the recovery of losses would be voluntary reserves, profit reserves and finally capital reserves (Sugino, 1998, p. 23). Since the 1950 amendment to the CC, companies could choose, by ordinary majority in the board of directors' meeting, to transfer the whole or part of the legal reserve back into the capital stock (1950 CC Art. 293-3-1). This new capital could be used to issue gratis shares to existing shareholders because the 1950 CC also introduced stock dividends and stock splits. Purchasing treasury stock was not allowed in Japan and could therefore not be used for stock dividends.

From a business perspective it is interesting to note that gratis share distributions were not taxed (because they were paid for by the capital reserve), whereas stock dividends were subject to taxation (because they came out of the

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[86] The CC and the BAP use different terms for the same thing (or what is supposed to be the same thing) so that people know which one is mentioned. I will follow the same logic using the word "surplus" referring to the concept under the BAP and the word "reserve" for the same concept under the CC. Capital surplus under the BAP is called *shihon jouyokin* (資本剰余金) and earned surplus under the BAP is called *ri-eki jouyokin* (利益剰余金).

[87] Legal reserves under the CC before amendment were called *houtei junbikin* (法定準備金).

[88] Capital reserve under the CC is called *shihon junbikin* (資本準備金) and profit reserve is called *ri-eki junbikin* (利益準備金).

[89] In 1950 the CC adopted the authorised capital system and allowed companies to issue non-par shares.

[90] Abolished in 1962 (CC Art. 288-2-3) when the historical cost convention was unequivocally adopted by the CC.

profit reserve) (Sugino, 1998, p. 27-28).[91] In theory stock dividends are used in case a company has accumulated earnings but does not have the cash available to distribute these earnings (Schroeder, Clark and Cathey, 2001, p. 459). Although recognised by accounting scholars as merely a reclassification of ownership interests, the general view among corporate managers in Japan at the time was that these additions to capital stock represented free capital increases (Sugino, 1998, p. 23; Nakamura, 1999, p. 87). Since the CC had established no upper limit to the share premium that could be added into the capital reserve, one could think that standard setters actually encouraged corporate managers to consider share premium and paid-in surplus as potential no-cost capital.

For reasons that have been discussed in Chapter 2, Japan's post-war economic reconstruction was increasingly financed by debt rather than by equity. Scrap and build policies aided by the Special Taxation Measures Law promoted capital investment in certain areas through accelerated depreciation measures. Ohta (1961a, p. 28-29) warned against dangers of the large-scale investments that were necessary for industrial modernisation and rationalisation in answer to the challenge of trade liberalisation, such as inflationary pressure and economic instability. Most of the investments in plant and equipment were financed through loans. Especially during the high-growth era, the main bank system played an important part in the distribution of financial resources and the functioning of financial regulations, thereby substituting the market for control (Okada, 1999, p. 87). It is therefore not surprising that political influence in the regulatory process favoured creditor protection over shareholder protection.

The general idea was that equity is risk capital in return for which shareholders receive limited liability and the right to dismiss directors if they disagree with a company's management policies. Creditors on the other hand have no such rights, and are at a distinct disadvantage to shareholders (Takeda, 2003, p. 116-118 and 120-122).[92] Therefore they need to be protected against the influence of shareholders, who were feared to have an opportunistic and speculative nature[93], on corporate management.

When management and ownership are not strongly separated, as is the case with many small *kabushiki kaisha*, creditors are indeed in a position that is more vulnerable to shareholders' moral hazard. With minimum capital requirements of JPY 3 million and a minimum of one founder, it was very easy to establish a joint stock company. This explains why there are roughly five hundred times more joint stock companies than there are listed joint stock companies.

Accounting standards for creditor protection in this period included the establishment of provisions (*hikiatekin*) by the CC in 1962. *Hikiatekin* are the third area of discrepancy between the CC and the BAP where one can clearly

[91] The English terminology used here simply follows Japanese usage.

[92] Although on pages 116-118 Takeda describes the situation in Germany in 1861, this is exactly what the general opinion seems to have been in Japan from 1890 until the early 1990s.

[93] This is possibly a legacy of the 1920s when there was a trend of large shareholders and corporate management teamed up to falsify company reports in order to pay out large dividends and bonuses even when no profits had been made. See: Teranishi (1999), p.70.

see the discrepancies within the Japanese accounting system. According to Ohta (1961b, p. 5), for a long time *hikiatekin* accounts were not well understood except by accounting scholars. Tax laws considered reserves and *hikiatekin* as retained earnings. Therefore, contributions to these accounts were treated as taxable profits. After World War II, depreciation allowances and allowances for irrecoverable accounts[94] came to be recognised, but not the *hikiatekin* of a liability nature. Legal scholars reasoned that an item on the credit side of the balance sheet and that is not a capital accounts item, must be a liability. But if there is no particular claimant for the *hikiatekin*, it cannot be a liability.

Art. 287-2 of the 1962 CC read: "When recording a provision for specific expenditures[95] or losses in the liabilities section of the balance sheet, its purpose shall be clarified in the balance sheet. When using this provision for a purpose other than the one for which it was established, the reasons for doing so shall be recorded in the profit and loss statement." Art. 287-2 marked the birth of "specific provisions" (*tokutei hikiatekin*). Under the BAP, provisions of a liability nature had to meet the conditions that the expenditures were highly likely to take place, found their cause in the previous accounting period, could be reasonably estimated, and the expenses could be matched with revenues (Annotations to the BAP, Note no. 18). An amendment to the BAP in 1963 got rid of the fourth condition so that provisions for losses and contingent losses could be established as well (Taguchi, 1970, p. 53-54). Provisions are in theory used to retain funds inside the company for anticipated losses or expenditures, but among business practitioners, the leading interpretation of CC Art. 287-2 was that provisions could be used for mere profit retention.[96] Indeed the very introduction of provisions into the CC had come about under notoriously strong pressure from the business community (Taguchi, 1970, p. 54). As the Special Measures Taxation Law followed the broad interpretation of *hikiatekin*, it allowed a large number and a broad range of provisions. Taguchi explains this stance as useful from the perspective of economic policy (Taguchi, 1970, p. 55).

The newly established provisions were partly countered by the extended scope of deferred assets that were recognised under the CC. To organisation costs[97] (1938 CC Art. 286), bond issuing premium[98] (1938 CC Art. 287), interest during construction[99] (1938 CC Art. 291-3), and share issuing costs (1950 CC Art. 286-2, 1962 CC Art. 286-4), were added start-up costs[100] (1962 CC Art. 286-2), bond issuing costs (1962 CC Art. 286-5), and experimental research and development costs (1962 CC Art. 286-3). From a creditor perspective,

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[94] 減価償却引当金 (*genkashoukyaku hikiatekin*) and 貸倒引当金 (*kashidaore hikiatekin*) respectively.

[95] 特定の支出 (tokutei no shishutsu)

[96] Popular examples of these were provisions for repairs (修繕引当金), provisions for special repairs (特別修繕引当金), provisions for the company's anniversary celebration, especially the 50th (記念事業引当金).

[97] 創業費

[98] Until the 1962 amendment to the CC bond issuing costs had to be deducted from bond issuing premium.

[99] 開業前の利息の配当

[100] 開業準備費

recognising deferred charges as assets in the balance sheet may cause the substance of assets that serve as collateral to be compromised (Okada, 1999, p. 124-125). Art. 290 of the CC was amended in 1962 to explicitly state the calculation method for the maximum amount of dividend payout as: net assets minus the total of capital stock, capital and profit reserves, this period's contribution to the profit reserve (i.e. 10 percent of cash dividends), and if applicable the deferred charges of Art. 286-2 and 286-3 mentioned above. After which directors bonuses still had to be paid (Sugino, 1998, p. 33). It seems fair to say that these amendments represent a big step towards creditor protection and away from protecting the rights of shareholders.

Although independent audits by an audit firm or CPA have been required by the SEL since 1949, the CC introduced independent audits only for large companies who already received independent audits under the SEL in 1974. Consolidated financial statements were also audited by an independent auditor under the SEL since 1978. Practical reasons for unification of the Japanese financial accounting system became more urgent because of the general agreement that it would be too costly if the independent audits under the CC and SEL had to be conducted separately.

1980-1996

An amendment to the CC in 1981 restricted the use of provisions so that mere profit retention was no longer allowed. CC Art.287-2 was amended to read: "Provisions for specific expenditures and losses can be recorded in the liabilities section of the balance sheet only to the extent that the amount corresponds with the expenditure or loss for the business year." Most companies would recognise provisions and allowances to the extent and for the maximum amount allowed by the Corporation Tax Law and the Special Measures Taxation Law. Through this amendment the CC forced the tax laws to take a narrower interpretation.

As of 1981 *hikiatekin* were divided into allowances and provisions under the Special Measures Taxation Law and others. Examples of the former are special depreciation allowances (Art. 52-3) and provisions for losses from overseas investments (Art. 55). These belong in the liabilities section and are called *junbikin*. Examples of the latter are provisions for warranties and service charges, returned goods, bonuses, and retirement benefits. All are called *hikiatekin* and are recorded in the liabilities section as well. Allowances for doubtful accounts and sales discounts are negative *hikiatekin* and are recorded in the assets and liabilities sections respectively (Hirose, 1998, p. 277-283).

In the 1970s the par-value stock system had become hollowed out. Although non-par stock had been allowed since 1950, most companies issued par-value stock with a par-value of JPY50. This represented about one month's salary in 1940 (Katagi, 2003, p. 54), but in 1980 that was already much less than a middle-school child's weekly allowance.[101] The par-value would go into capital stock, and the share premium into capital surplus. During the high-growth era actual paid-in capital would be much higher than par value, so by 1980 capital stock would be much smaller than capital surplus. Dividends were usually five

[101] According to my friend Atsuko Kawaharada.

yen per share (10% of par value), and managers came to consider the share premium as no-cost capital that they used to pay stock dividends.

In order to deal with this situation the 1981 CC amendment required half of the paid-in capital to go into the capital stock. For non-par stock that had been issued at the time of establishment of a company, half of the amount over JPY50,000 was to be accounted for as capital stock. At the same time, the "unit stock system" (*tan'i kabu seido*) was introduced. This means that companies had to issue stock in units of at least JPY50,000 (Sugino, 1998, p. 39-43). So for shares with a par-value of JPY50, a company would have to issue one thousand shares in one unit. In addition, in order to be allowed to pay stock dividends, net assets per share had to be more than JPY50,000 after distribution of the gratis shares. As a consequence, after 1982 there was trend away from stock dividends towards stock splits (Sugino, 1998, p. 43-46). In 1990 an amendment to the CC effectively abolished stock dividends (Nakamura, 1999, p. 88).

Although preventing the capital stock from hollowing out as described above could be considered a measure of shareholder protection, it actually serves creditors well too (Katagi, 2003, p. 56). As the earned surplus is based on the capital stock (a maximum of one fourth of the capital stock) an increase in capital stock will lead to an increase in non-distributable earned surplus (Sugino, 1998, p. 54-55).

In a response to the US demands made during the structural impediments talks an emergency revision of the CC was carried out in 1993. The demands were:

1. improved access to company accounts for shareholders (lowering the threshold for inspection of the books from 10 percent of the shares to 1 percent)
2. a longer period between the invitation to the annual shareholders meeting and the actual meeting (from 2 weeks to one month)
3. the establishment of an auditing committee consisting of directors from outside of the company
4. relaxation of the rules limiting purchase and holding of treasury stock in order to further dissolution of mutual shareholdings
5. the establishment of a system that will guarantee voting right of non-resident shareholders

Actual amendments consisted of the following. Reduced litigation costs for shareholders (Art. 267-4). Shareholders possessing at least 3 percent instead of 10 percent of a company's shares can ask for inspection of the company accounts (Art. 293-6). The maximum period for a statutory auditor was increased from two to three years (Art. 273). The limit to issuing corporate bonds was lifted (Art. 297) (Kawamoto *et al*., 2002, p. 49).

Up until the 1994 amendment to the CC the purchase of treasury stock had been forbidden, except in four cases:

1. for the purpose of share elimination (Art. 210.1),
2. in case of merger or at the time of transfer of total operations to another company (Art. 210.2),
3. when the shares are necessary to exert control over the company (Art. 210.3),

4. to repurchase the shares from opposing shareholders at the time of a merger.

In 1994, two more occasions in which repurchase of treasury stock was permitted were added. One was in order to transfer the stock to employees (Art. 210 No.2). The second was an exception for joint stock corporations that limit transfer of stock in their articles of incorporation (Art. 210, No. 3). For example when shareholder A intends to transfer his shares to B, but B does not get the board of directors' approval for the transfer, the company may repurchase the treasury stock. Another example is when a stockholder dies and the successor who inherited the stock wishes to sell them. The reason is that it may prove difficult to find a buyer for shares in a company that limits transfer of its stock (Nakamura, 1999, p. 89).

The 1994 amendment to Art.210 of the CC relaxed the regulations for the purchase of treasury stock as above. A maximum of 5 percent of outstanding shares could be purchased as treasury stock. Although the CC did not prescribe any accounting treatment, Note 18 to the FSR stipulated that treasury stock shall be recorded in the current assets section of the unconsolidated balance sheet. In other words treasury stock was meant to be held for a maximum of one year. Disclosure was only required if the amount was more than 1 percent of the amount of total assets (FSR Note 19).

Relaxing the restrictions on the purchase of treasury stock permitted corporate management more flexibility in reorganisation. Restructuring procedures had become increasingly necessary because many companies and financial institutions were in trouble due to the prolonged economic depression.

1996-2003

From 1997, the Commercial Code allows repurchase of treasury stock for the purpose of capital reduction (Art. 212, No. 2). Procedures for capital reduction were established in "The Law Regarding Exceptions to the Commercial Code Concerning the Elimination of Shares" issued on May 21, 1997 as law number 55. This decision needed approval of the general shareholders meeting as well as the board of directors. As an alternative way of dealing with stock options, since 1997, the Commercial Code gives employees the right to subscribe to newly issued stock (art. 280-19) (Nakamura, 1999, p. 89).

The 1997 amendment to the CC allowed the purchase of treasury stock for the purpose of stock options. Because hitherto treasury stock had been classified as a current asset, a problem arose due to the fact that stock options usually have maturities of more than one year. In the unconsolidated balance sheet prepared under the CC treasury stock with a maturity of less than one year was to be recorded in the current assets section, and treasury stock with a longer maturity was to be recorded in the fixed assets section. Losses or profits on sale were disclosed as non-operating income. In consolidated financial statements (prepared under the SEL) treasury stock appeared in the balance sheet deducted from stockholders equity (Ito, 1998, p. 368-369). The CC treated treasury stock as assets because it adhered to the legal entity concept where any asset that can be sold should be treated as an asset for the purpose of creditor protection. An amendment to the CC in June 2001 constituted a shift

toward the economic entity perspective which treats treasury stock as a capital reduction.

Simplified procedures for mergers were established. Art. 56 says that a joint stock corporation can be the result of a merger. According to Art. 408, a merger contract shall be approved by the general shareholders meeting. Merger procedures were laid out in Art. 408-2, Art. 412, and 414. Art. 413-3 stipulated that new shares issued by the company shall not exceed 5 percent of the total number of its shares outstanding.

Under the previously mentioned "Law Regarding Exceptions to the Commercial Code Concerning the Elimination of Shares" companies who had profits for distribution could purchase treasury stock for the purpose of elimination of profits. (CC Art. 212) After the 1998 revision, companies could also use capital reserves (*shihon junbikin*) for the elimination of shares (Art. 288 No. 2-1-4).

Revision of the Anti-Monopoly Law in 1997 lifted the ban on holding companies. In order to facilitate the establishment of holding companies, the Commercial Code was amended to allow conversion (Art. 352 to 363) and transfer (Art. 364 to 372) of stocks. Rationalisation of the system for mergers and providing a legal framework for mergers necessitated rules for full transfer of operations (Art. 245-5). The process for company split ups is regulated by Art. 373 and Art. 374-1 to 31.

In 2001 the Commercial Code was amended three times. The first amendment concerned abolishing the *tan'i* stock system and replacing that with the *tangen* stock system[102]. The former provided a bottom limit of JPY50,000 to the amount (value) of shares to be issued in one unit. The latter provides a maximum number of shares that can be issued per one unit, and one unit represents one vote in the general shareholders meeting. The unit and the maximum number of units are to be determined and laid down in the articles of corporation. One unit cannot exceed 1,000 shares or 0.5 percent of the total number of shares issued (Art. 221-1). Thus also the system of par-value shares has been abolished. Shareholders that own less than one unit of stock have no voting rights and no right to ask questions in the annual shareholders meeting (Kawachi, 2003, p. 39).

Lifting the restrictions on purchasing and holding treasury stock (Art. 210) constitutes a major item of the amendment. Hitherto, decisions on treasury stock had to be made by the general shareholders meeting. From now on, the decision to purchase treasury stock and what to do with it are at the discretion of the board of directors (Art. 211). Treasury stock will no longer appear in the balance sheet as an asset, but as a negative item in the capital section.

In an attempt to increase a company's methods of raising capital, the second amendment to the Commercial Code allows a greater variety of shares that a company can issue. Convertible stock, mandatory convertible stock (the issuing company decides when the conversion takes place), shares with limited voting rights, preferred or subordinated shares greatly expand the range that a

[102] Both tan'I and tangen translate into English as "unit". The Ministry of Justice translates tan'i stock system as "lot" stock system, and tangen stock system as "voting unit" stock system. See "*Japanese Corporate Law: Drastic Changes in 2000-2001 & the Future*" at http://www.moj.go.jp.

company can choose from (Art. 222 No. 2 to 10).

Furthermore, redefinition of the legal concept of warrants enables companies to sell stock purchase warrants as separate and independent securities. Unlike before, stock options may now be granted to people other than employees or directors of the issuing company. (Art. 280-19 to 38) The same system applies to bonds with warrants attached (Art. 341-2 to 15).

Another important aspect of the second amendment made it possible to incorporate information technology into the disclosure system. Companies are required to present their financial statements to the Ministry of Justice in electronic form (Art. 33-2, and Art. 281). Shareholders who are unable to attend the annual shareholders meeting can submit their vote per computer (Art. 239-3).

The last amendment to the Commercial Code in 2001 may bring about important changes in the corporate governance system of joint stock corporations. Directors' responsibilities have been alleviated somewhat, and the function and position of statutory auditors has been strengthened somewhat. Statutory auditors no longer have the obligation to attend every board meeting, but if there is a need and they neglect their duty to express their opinion on certain matters, they may be held liable for possible negative consequences for the company (Art. 260-3).

As for the number of outside statutory auditors before the revision, Art. 18 of the Law concerning the exceptions to the Commercial Code required at least one out of four statutory auditors to be from outside the company. The concept of "outside" was understood as not having been an employee of the company concerned or one of its subsidiaries in the five years up to the appointment. Presently, in case there are more than three statutory auditors, at least half of them should be from outside. "Outside" meaning never having been employed at the company concerned or at one of its subsidiaries (Ohta, 2002, p. 182). The term for statutory auditors has been extended from three to four years (Art. 273-1).

Shareholders can file a complaint against a company's directors when they suspect negligence, if they have held stock in the company for more than six months (Art. 267-1). Directors can be made to pay for neglecting their duties and thus damaging the company for a maximum of four years of salary, two years of salary for outside directors, and six years of salary for representative directors (Art. 266-18).

The mechanics and institutions of corporate governance constitute the central issue of the 2001 amendment to the CC. Some consider the Heisei recession as having partly originated in failure of the governance system. Therefore, these new regulations may have a beneficial impact on companies' ability to overcome the recession.

The 2002 amendment has given large companies (with a capital stock of over JPY500 million) and so-called large companies (with a capital stock of between JPY100 million and JPY500 million) having ten or more directors including one outside director[103], the choice to change their governance

[103] The companies shall record their choice to be a "company with committees" in their articles of incorporation, which of course can only be amended through a decision by the general

structure by establishing committees (Special Law for the Revision of the Commercial Code, Art. 21-5). Having changed its articles of incorporation, the company may then establish three committees named appointment committee, auditing committee, and compensation committee. The purpose of these committees is to alleviate the board of directors of some of its responsibilities.

Responsibilities of the appointment committee include deciding on the proposal for appointment or removal of directors to be presented to the general shareholders meeting. The auditing committee audits the operations of officers and directors, and performs the internal auditing of the accounts. In addition, the auditing committee decides on the choice of external auditor. Furthermore, the board of directors has the authority to appoint an auditing committee (Special Law Art. 21-8-2-1) in lieu of the statutory auditor under the old system. Remuneration of directors and officers is the main task of the compensation committee (Kawachi, 2003, p. 92-93).

In case of important issues such as amending the articles of incorporation, decisions are not made by a simple majority of the votes (half plus one) but by a special majority (two thirds) (Art.343-1). At least one third of the shareholders with voting rights have to cast their vote, otherwise the decision cannot be taken (Art. 343-2). Hitherto, half of the voting rights had to be represented in the vote. One might say that passing decisions has become easier. Interesting is that this decision has been motivated by the idea that in the days to come more and more shares will be held by smaller shareholders.

Large companies that are not a “company with committees” but do have more than ten directors including one outside director, may establish an “Important Assets Committee” (Special Law Art. 1-3). This committee will make the decisions concerning the acquisition or disposition of important assets, or concerning large borrowings (Takagi, 2002, p. 27).

Already in 1997 the CC had been amended to allow the purchase of treasury stock for the purpose of stock retirement and capital reduction using the capital reserve. As of 2001 the CC allowed the purchase of treasury stock irrespective of the purpose, as long as it was within the limit of the distributable earnings amount (Art.210) (Katagi, 2003, p. 61). After revision the CC required the total of profit reserve and capital reserve to be a maximum of one fourth of capital stock (Art.288). This is a return to what it was before 1950, and it means an effective reduction of the size of the legal profit reserve.

The annual shareholders meeting can decide by an ordinary majority to use the part of the legal reserve that is over the minimum of one fourth of stated capital stock (Takeda, 2003, p. 505) for the purpose of repayment to shareholders or for compensation of losses (Art.289). Repayment of contributed capital had been forbidden except in case of capital reduction and stock retirement.

In sum, creditor protection has been a dominant concern in Japan’s accounting system. This took the form of explicit dividend restrictions, a liberal stance toward reserves and discretionary provisions (particularly between 1962 and 1981), the possibility to use share premium and paid-in-surplus as no-cost

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shareholder meeting.

capital (until 1981). The introduction of consolidated financial statements under the SEL represented a first step toward increased disclosure for shareholders and future investors. Over the years the focus of accounting standards has shifted more toward shareholder protection and transparency.

Especially since 2001 the CC enables companies to choose corporate governance institutions that are deemed more transparent. Furthermore, shareholders have more possibilities for recourse. Illustrative of the fact that Japan has had a long history of marked prevalence of creditor protection is Takeda's remark that the risky nature of shareholder capital has gradually diluted. He called this phenomenon the "debtisation of equity".[104] *Allowing the purchase of treasury stock for the purpose of stock options in 1997 prepared the way for the 2001 shift in the CC from considering treasury stock as an asset to treating it as a capital reduction. In essence, this means departure from the legal entity concept toward the economic entity concept.*

3.1.4. Status of consolidated financial statements

1945-1980

Irrespective of Japan's history of zaibatsu and keiretsu, consolidation accounting was only scarcely practised, starting from 1960. The first company in Japan to issue consolidated financial statements was Hitachi Co. Ltd. aiming to be permitted to have its shares traded in New York via American Depository Receipts (ADRs). The US SEC permitted Sony ADRs to be traded over the counter on June 6, 1961. Hitachi ADRs were allowed from July 1963. From 1964, in cases such as mergers or changes of financial year, the Tokyo and Osaka Stock Exchanges requested submission of consolidated financial statements. Such was the consequence of several financial failures of affiliated companies of large listed corporations that had practised window dressing.[105]

As there were no standards concerning consolidated financial statements, the Finance Minister asked the BADC to deliberate on codification of standards for strengthening the auditing system, and standards for consolidated financial statements. The BADC issued the "Opinion Relating to Consolidated Financial Statements" and the "Notes to the Opinion Relating to Consolidated Financial Statements" on May 19, 1967. However, as the BADC noted in its "Opinion", consolidated financial statements were new to Japan and generally accepted accounting practices with regard to the preparation thereof had to be reinvestigated and formulated in the stage of systemisation.[106] First and foremost, the "Opinion" stressed the importance of consolidated financial statements. Secondly, it provided consolidated accounting standards on:

1. general principles
2. the scope of consolidation
3. differences in accounting periods between parent and subsidiary

[104] (資本の負債化), see Takeda (2003), p. 509.
[105] See Kuroda (2001), p.1813-1821 for a history of consolidated accounts in Japan.
[106] BADC, (1967/5/19) "Opinion Relating to Consolidated Financial Statements"

companies
4. differences in the adoption of accounting principles between parent and subsidiary companies
5. the preparation of consolidated balance sheets
6. minority interests
7. the preparation of consolidated profit and loss statements
8. information to be included in footnotes
9. tax payment

The "Explanatory Notes to the Opinion Related to Consolidated Financial Statements" laid out the consolidation process in detail. These standards served companies issuing consolidated financial statements until the next BADC opinion on this subject.

Finally, on June 24, 1975, the BADC issued the "Opinion Relating to the Systemisation of Consolidated Financial Statements". The MOF adopted the "Opinion on Systemisation" on October 30, 1976, and from April 1977 Japanese companies were to issue consolidated financial statements as supplementary documents to the parent company financial statements under the Securities and Exchange Law. The provisions were laid out in the "Ministerial Ordinance Concerning Terminology, Forms and Methods of Preparation of Consolidated Financial Statements" as Ministerial Ordinance No. 28. Until a thorough revision of the consolidation accounting system in 1997, the standards provided by the "Opinion on Systemisation" remained the basis of the system for twenty years (Morita *et al*., 2000, p. 6).

Ministerial Ordinance No. 28 additional clause No. 2 (issued in 1976 as additional clause No. 3), stated that for the time being, consolidated financial statements according to US-GAAP and filed with the SEC in the US, if recognised and approved by the Japanese Finance Minister, could be issued instead of consolidated financial statements according to Japanese financial accounting standards.

1980-1996

The perceived importance of consolidated financial statements increased slowly. Initially, consolidated financial information was to be submitted within four months from the closing date. For unconsolidated financial statements the term was three months. This discrepancy ceased to exist from April 1, 1988. Furthermore, from April 1, 1991, consolidated financial statements were to be submitted as independent statements rather than as supplementary documents following an amendment of the Disclosure Ordinance[107] on December 25, 1990 (Morita, 1999, p. 46).

According to Art. 10 of the Standards for Consolidated Financial Statements[108] (CFS), the *equity method* applied to investments in associated companies and unconsolidated subsidiaries. Exceptions were, companies excluded from consolidation on grounds of non-going concern or restart, or of a temporary majority of voting rights (CFS Art. 5), or where voting rights of over 20

[107] 企業内容等の開示に関する省令
[108] 連結財務諸表規則

percent of the total were merely temporary (CFS Art. 10). However, many companies valued their investments in associates at the historical cost price, and considered dividends received as income from investments, like they did in unconsolidated financial statements. It was perfectly legal to do so as additional clause No. 2 read: “For the time being, it is possible not to apply Art. 10.” The equity method became the enforced standard from April 1, 1983, after repulsion of additional clause No. 2.

In May 1989, the BADC issued its “Opinion Related to the *Disclosure of Segmental Information*”. Subsequently, on September 20 of the same year, the Ministry of Finance amended the Disclosure Ordinance to incorporate the BADC’s opinion statement into the law. For the time being, it was possible not to disclose operating profits or losses per geographical segment (Morita *et al*., p. 7). From April 1, 1990, companies under the SEL were required to disclose sales and operating income or loss per industry, and per geographical segment (domestic and overseas), as well as total overseas sales (exports).

The “Disclosure Opinion” considered it necessary to provide segmental disclosure as part of the financial statements so the information would fall under the obligatory external audit. Nevertheless, the “Disclosure Opinion” stated that it was unavoidable to provide segmental disclosure as additional information for now, and that the auditing of segmental disclosure needed to be reconsidered within the next five years. From April 1, 1993, following an amendment of the “Standards for Consolidated Financial Statements” (Art.15-2) on March 3, segmental disclosure was to be included in the notes to the financial statements. And thus became a part of the securities report that had to be submitted to the MOF and therefore became subject to external audits under the SEL.

Art. 15-2 prescribed considerable increase of the contents of segmental disclosure as follows. Disclosure per business segment included sales, operating profits or losses, total assets, depreciation expenses, and capital expenditures. Actual enforcement of disclosure of operating profits or losses per industry started from April 1, 1994. Business segment disclosure of assets, depreciation expenses and capital expenditures was mandatory from April 1, 1995. Geographic segment disclosure consisted of sales, operating profits, and assets. Until April 1, 1997, companies could choose not to disclose these items per region or country of residence for their subsidiaries. Instead they disclosed these items for the home country (Japan) and for all overseas countries lumped together (Morita, 1999, p. 47-48).

Other amendments to the consolidated disclosure system are as follows. From 1985, companies were required to submit an “Outline of business results and important items related to the circumstances of the business group” as an attachment to the consolidated financial statements.

The Fifth Structural Impediments Initiative meeting held from June 25 to June 28 1990 resulted into significant nominal enhancement of consolidated disclosure requirements. A major point on the agenda for Japan was the so-called *keiretsu problem*. From the viewpoint of US investors, for whom consolidated accounts were the rule, the relations between companies within keiretsu were rather opaque. In order to improve transparency for foreign investors, creditors, and potential business partners, the Japanese government

promised the following improvements.

1) Disclosure of related-party transactions at par with FASB Statement No.57.
2) Disclosing consolidated financial statements in the primary annual statement rather than as an attachment.
3) Segmental disclosures (Saito, 1995, p. 18-23)

And thus, following the Fifth Structural Impediments Initiative, due to amendment of the “Disclosure Ordinance” on December 25, 1990, the MOF required the un-audited disclosure of transactions with related parties[109] as of April 1, 1991, appended to the consolidated financial statements. Art. 1-27-5 of the Disclosure Ordinance required disclosure of the parent company, subsidiaries, associated companies and their parent and subsidiary companies, the main shareholders, and names of people or companies that have an important influence of business and financial policies of the company. However, these disclosures were not subject to an independent audit.

The above mentioned independent status of the consolidated financial statements since April 1, 1991, as well as the segmental disclosure requirements that were not really required, and related party disclosures are a consequence of the Structural Impediments Initiative.

Consolidated research and development activities disclosures became mandatory from April 1, 1993. The next year saw an enlargement of the scope of consolidation due to abolishing the 10% rule. Hitherto, companies were at liberty to exclude subsidiaries from consolidation or applying the equity method, if their sales, assets or profits amounted to less than 10 percent of the group total (Morita, 1999, p. 48).

1996-2003

The Accounting Big Bang entailed an overhaul of the accounting system as part of which consolidated financial statements became the primary financial reports. Following its exposure draft in February 1997, the BADC issued its “Opinion Related to the Revision of the Consolidated Financial Statements System” in June of the same year. One part was concerned with the completion of the disclosure system, and the second part dealt with the revision of the “Consolidated Accounting Principles”.

Completion of the disclosure system was to be attained through reversing the positions of consolidated and unconsolidated accounts, attaching higher importance to consolidated accounts. Furthermore through the introduction of consolidated cash flow statements, consolidated interim financial statements, and consolidated temporary reports, and through making these (except for the latter) subject to external audits (Nomura, 1999, p. 10).

Other new aspects included the disclosure of contingencies and post-balance sheet events on a consolidated basis, the disclosure of business results and the situation of the business group along industry lines. The contents of the second part included: revision of the scope of consolidation and of disclosure of minority interests, adoption of tax effect accounting, clarification of

[109] 関連当事者との取引

the consolidation process and rules for differences in accounting treatment, and a revision of the disclosure format (Morita, 1999, p. 49-51). Related party disclosures are included in the notes to the consolidated financial statements since April 1, 1999.

Amendment of the related Ministerial Ordinances, new Ministerial Ordinances, and new JICPA guidelines in place, the provisions of the “Opinion Related to the Revision of the Consolidated Financial Statements System” became legally enforceable from April 1, 1999. Changes in regulations related to consolidated financial statements forced companies to adopt a group-oriented approach to management. These changes include: 1. Primary status of consolidated financial statements including the new consolidated cash flow statement, 2. taxation on a consolidated basis, 3. and the introduction of consolidated financial statements for large companies under the CC.

Pondering why it took so long for consolidated financial statements requirements to be introduced (from around 1965 to 1978), and why it has taken even longer for consolidated financial statements to receive full primary status under both the SEL and the CC (from 1978 until 2004), the following explanations come to mind. In the 1960s Japan faced the scandals related to window dressing such as Sanyo Special Steel Company’s fraudulent bankruptcy which made the need for consolidated financial statements and better auditing apparent. At the same time, thin capitalisation of Japanese companies invited the threat of hostile foreign takeovers. The answer was found in stable mutual shareholdings. Stable shareholders were Japanese individuals or corporations who could be counted upon to hold on to their shares irrespective of losses, low or no dividends, and attractive offers by foreign interests. It worked very well, as was demonstrated in 1989 when T. Boone Pickens was unable to obtain more than 26 percent of the voting shares of Koito Manufacturing Company (Lowe, 1990, p. 7).

The business community stalled the introduction of consolidated financial statement standards as long as it could, and when they were finally there, consolidated financial statements disclosed hardly any information in the notes. Secondary status, lower disclosure requirements, and consolidation standards regarding the scope of consolidation rendered Japanese consolidated financial statements incomparable because of the 10 percent rule, and because legal ownership and control were often detached. Stable shareholdings developed before the introduction of consolidated financial statement standards that adopted consolidation requirements based on legal control rather than effective control, thus encouraging mutual interlocking shareholdings as a means to defend against hostile take-overs.

The fact that the CC finally adopted consolidated financial statements for large companies in 2002 (effective from April 1, 2004) and that for these companies taxation on a consolidated basis was introduced seems to indicate that these changes only took place when they were deemed advantageous to Japanese corporations in order to lower the tax burden. It appears that the changes did not take place primarily for the purpose of supplying information to investors and other interested parties, but rather to suit the needs of the businesses preparing the financial statements. Another motivation is presenting

the image that Japanese accounting standards are now at par with those of the rest of the advanced world.

3.2. Accounting Concepts and Approaches

Accounting theory, in as far as it exists, is not clear on what determines the choice for certain concepts and approaches. At the very least, one may expect the choices in accounting concepts on which the system is based and the approaches that the system follows to be in conformity with the characteristics of the accounting system. In practice however, seemingly contrarian approaches are not always mutually exclusive.

3.2.1. Determining profits

If one chooses to determine profits for the period based on a comparison of beginning and ending owners' equity, the so-called balance sheet approach or asset-liability approach, it is very important to determine the value of equity correctly, and in times of inflation value assets at market prices rather than at historical cost prices. The resulting net worth is instrumental in the legal entity concept especially from the viewpoint of creditors. It is also close to economic income defined as disposable income. Until the 1930s the asset-liability approach was general practice in the US (Robinson, 1991, p. 107), and until the start of the post-war period in many other countries including Japan. In the 1980s the asset-liability approach was adopted again by the FASB as the basis for its accounting standards, but this time it was not necessarily linked with current cost (Robinson, 1991, p. 107-108).

If, on the other hand, one chooses to determine profits as the difference between revenues and expenses, the balance sheet becomes a tool for matching the revenues and expenses for the period correctly. This is called the income statement approach but is probably better known as the transactions approach (Schroeder, Clark and Cathey, 2001, p. 139). Income determined as the result of the transactions approach is closer to the concept that views a company as an economic entity. Confusingly, income thus defined is viewed as accounting income rather than economic income. Application of the realisation principle prohibits the inclusion of unrealised holding gains or losses in the estimation of profits for the period. Hence the historical cost price for the valuation of assets is the most conservative choice.

1868-1945

As the accounting provisions in the Commercial Code were modelled on the Franco-German continental type of regulation, it viewed a company as a legal entity and it followed the balance sheet approach for the determination of profits. 1890 Commercial Code, Art. 32 literally requires assets to be valued at "the current price or the market value"[110], the 1899 Commercial Code Art. 26 says to use "the price at the time of preparation of the inventory" (= current price), 1911

[110] 当時の相場又は市場価値

Commercial Code Art. 26-2, reads that the valuation “is not to exceed the price at the time of preparation of the inventory”, thus establishing the current price as a maximum, which is not the same as the lower-of-cost or market rule. This remained unchanged in 1938 Commercial Code Art. 34, which adds that fixed assets for business use shall be valued at the cost price depreciated by a proper amount. Judging from the above one could conclude that since 1911 valuation at cost price was the rule. Any revaluation gains would be taxed, which is why revaluation was not generally practiced.

After revision in 1938 the CC recognised organisation expenses (Art.286), bond discounts (Art. 287), and pre-operating period interest (Art. 291-3) as deferred charges. This change may first be viewed as a first tiny step toward increased influence by accountants in the regulatory process. Secondly, it implies recognition of the fact that a company is also an economic entity.

1945-1980

In addition to the accounting system under the Commercial Code (CC), in 1949 a new accounting system under the Securities and Exchange Law (SEL) was introduced for listed corporations. The CC still followed the balance sheet approach to determining profits, whereas the SEL introduced the matching principle and valuation principally at cost basis.[111] So the SEL required the practice of accrual accounting, and followed the income statement approach to the determination of profits. This was obviously a very confusing situation for listed companies having to present their shareholders with a set of financial statements in accordance with the CC, and having to present the Ministry of Finance with a set of financial statements following the Business Accounting Principles (BAP) and the SEL. CC amendment in 1950 recognised new share issuing expenses as deferred charges. Under the old CC these had been deducted from the share premium part in the legal reserve (Fujita, 1991, p. 166). In addition the legal reserve was divided into a legal capital reserve and a legal profit reserve (Fujita, 1991, p. 73). The implications with regard to creditor protection have been discussed in the section 3.1.3. and consequences for operating capital maintenance will be discussed in section 3.2.2.

The BADC issued several opinions on the unification of the system, but it took twelve years for this particular discrepancy between the CC and the SEL to be resolved by an amendment to the CC. As of 1962, the CC followed an income statement approach to the determination of profits. The basis for valuation changed to historical cost price, with the obligation to use the lower of cost and market price for inventories in case the current price was remarkably lower than the acquisition or manufacturing price and the price was not expected to recover. In case it was considered possible that the price could recover, the lower-of-cost-and-market rule was allowed but not compulsory. (1962 CC Art. 285-2) The same applied to investments in bonds (Art. 285-5) and stocks (Art. 285-6).

At the same time Art. 288-2-3 was deleted, which means that since 1962 revaluation reserves and provisions were no longer allowed as a part of the

[111] Valuation of inventories was to be at the lower of cost or market price. For marketable securities the SEL required realisable value. See Fujita (1991), p. 156.

capital reserve. Valuation profits were forbidden (Hirose, 1998, p. 153), as is consistent with the realisation principle. In case of application of the lower-of-cost-and-market rule there was still a possibility for upward revaluation if the price did turn out to recover after all, by use of the *araikae* method.[112] This translates as "wash and change" method which roughly corresponds to the indirect method[113] that uses an allowance account. Under this method the current price at the time of market value recovery is compared to the historical cost price instead of the price at the time of the write-down. The allowance account can be used for upward revaluation to a maximum of the historical cost price. Another method allowed in case of write-downs when using the lower-of-cost-and-market rule is the *kirihanashi*[114] or cut-off method in which case the loss ends up in the income statement under cost of goods sold, non-operating expenses, or special losses.

In order to facilitate period matching the CC allowed the use of provisions for the first time in 1962, and also extended the scope of deferred assets to include bond issuing expenditures, R&D expenditures, and start-up costs (see section 3.1.3.). The ambiguous formulation of provisions enabled an interpretation to include any profit retentions as long as they were specific. Furthermore, 1950 CC Art. 290 specified the calculation method for the maximum amount that can be paid out as dividends.

1974 saw an amendment to the CC that was mainly meant to unify the audit systems of the CC and the SEL. With respect to the determination of profits it is important to note that the preparation of an inventory list was no longer required, and that the lower of cost and market valuation of the shares of subsidiaries was no longer allowed (Arai, 1999, p. 126-127). Instead, historical cost applied to investments in subsidiaries.

1980-1996

In 1981, another amendment to the CC took place. It required the specific purpose for provisions to be disclosed and did away with specific provisions merely for the purpose of profit retention. Other aspects of this amendment have been discussed in section 3.1.3. Throughout the whole period the transactions approach to the determination of profits and accrual accounting reigned supreme.

1996-2003

Market value or fair value became an accepted valuation method for financial assets through an amendment of the CC in 1999 that is effective as of March 2001. This amendment occurred in order to bring about harmonisation with international standards (Takeda, 2003, p. 148). It also supported the "Accounting Standards for Financial Instruments" that were issued by the BADC in January of 1999 (Katagi, 2003, p. 83).

The temporary "Law Pertaining to the Revaluation of Land" of March 31, 1998 is a special measure that enables financial institutions and other

[112] 洗い替え方式
[113] For the indirect method see Kieso and Weygandt (1998), p. 452-454.
[114] 切り放し方式

companies to boost their equity capital. It was meant to be temporary, but has been extended twice already. A maximum of two thirds of the holding gain can be used to purchase treasury stock, but is not supposed to be paid out as dividends (Katagi, 2003, p. 86).

"Accounting Standards for the Impairment of Fixed Assets" were issued by the BADC in August 2002, and are effective from April 1, 2005. They represent another step away from the historical cost principle and towards a more static balance sheet function, in line with international developments.

In sum, true to her code-law country nature, Japan's financial accounting system embraced the legal entity concept of enterprise because the regulators from the Ministry of Justice were legal specialists. Japan's accounting system in the form of the Commercial Code adopted the balance sheet approach to determining profits because from a legal standpoint this is best for creditors in case of a dispute or liquidation. Starting in 1938 the CC recognised deferred charges, indicating increased influence from accounting professionals.

The schizophrenic situation where the CC adhered to the balance sheet approach and the SEL adopted the income statement approach lasted from 1948 until 1962 when the CC unequivocally adopted historical cost price valuation, extended the scope of deferred charges and allowed the use of "specific provisions" very liberally. The scope for the use of specific provisions was narrowed considerably through amendment to the CC in 1981. Recent introduction of fair value accounting for financial instruments (2001) and the impairment of assets (2005) means a partial return to the balance sheet approach toward the determination of income. This time the shift is not motivated by the legal entity concept and creditor protection, but related to risk assessment and investment decisions. Due to the subjective nature of discount rates used in determining fair value it actually represents a shift toward seeing the company as an economic entity rather than a legal entity.

3.2.2. Capital maintenance

Another choice that needs to be made is one regarding the determination of income for distribution concerns the approach to capital maintenance. Profit according to the concept of operating capacity capital maintenance results only when after providing for physical replacement of productive capacity a financial increase in net worth occurs. Money capital maintenance is attained if there is an increase in the money amount of net assets. In both cases profits cannot be the result of transactions with shareholders or owners. Physical capital maintenance corresponds with valuation at current cost or replacement value which is also used under the asset-liability approach to profits. Money capital maintenance traditionally comes with valuation at historical cost and the income statement or transactions approach to profit. Financial capital maintenance is a concept in between money capital and physical capital maintenance because it adjusts for purchasing power parity (Elliott and Elliott, 1996, p. 61). Both physical and financial capital maintenance have the consequence of protecting creditors' interests.

There are two aspects to the concept of capital maintenance. One aims at protecting the continuity of a business by making sure that profits for distribution are not the result of inflation, by creating a revaluation reserve. Since 1962 the Japanese CC has not allowed revaluation provisions or reserves to be established as part of the capital reserves, and has only recognised revaluation reserves in exceptional cases which will be discussed below. Inflation has not been a serious problem for the past twenty odd years in Japan. Consequently, in recent times the choice for physical or monetary capital maintenance approaches has become a theoretical problem rather than a practical one, except in the case of foreign currency translation and the valuation of securities at market value.

The other aspect aims at protecting creditors through the creation of statutory or legal reserves that cannot be paid out as dividends. Paid-in capital is usually not allowed to be distributed as dividends to shareholders. Theoretically, capital and legal reserves serve to protect creditors from undue income distributions and revaluation provisions serve to avoid a hollowing-out of a company's assets. Distributable reserves can be provisions or reserves appropriated for specific purposes. An accounting system's approach to the distribution of capital surplus and earned surplus depends very much on its stance towards creditor protection. See section 3.1.3. for a discussion of this type of capital maintenance.

1868-1945

As we have seen in section 3.2.1., the 1890 CC stipulated valuation of assets at market price. In 1911 an amendment changed the general valuation basis to a maximum of current cost. From 1938 the CC added that fixed assets for business use were to be valued at the cost price depreciated by a proper amount. Valuation increases were subject to taxation. In 1911 the CC swung from current cost valuation to historical cost valuation embracing a not so strict monetary capital maintenance concept in the process.

The 1899 CC required that a legal reserve be established to which five percent of every period's profits and the total of share premiums should be added until the reserve amount reached twenty-five percent of the company's total capital stock. (1899 CC Art.194) Dividend payments were only allowed after profit retention into the legal reserve and were not allowed when the legal reserve had been used for the recovery of losses. (1899 CC Art.195)

1945-1980

After World War II inflation soared. As part of a successful attempt to address this problem revaluation of fixed assets was allowed three times. In this special case, the CC allowed a revaluation reserve. So after the war, the Commercial Code followed an operating capital maintenance approach whereas the new SEL (and BAP) supported monetary capital maintenance by adhering to valuation at the historical cost price. As in the case of the approach to determining profits in section 3.2.1., this particular discrepancy continued until the amendment to the CC in 1962. By adopting the historical cost valuation basis, the CC shifted to monetary capital maintenance. Although the

lower-of-cost-or-market price was allowed, it was only mandatory when it was perceived that there was no chance that the market price would recover from an extreme drop. Many company managers took an optimistic stance and did not use this option.

However, the choice of cost calculating methods such as lifo or fifo still gave companies a way to mitigate the effects of inflation. In the same way, in the times of adverse exchange rates after the breakdown of the Bretton-Woods system, companies could choose for either the historical exchange rate or the current rate of conversion.[115]

1980-1996

Throughout this period both the SEL and the CC adhered to the concept of monetary capital maintenance. Even though stock prices came crashing down hard in 1990 and 1991 still many companies did not use the lower-of-cost-or-market rule. This turned hidden reserves into hidden losses. Creditors such as banks and other lenders should have been protected by the lower-of-cost-or-market rule by keeping assets without substance from the balance sheet. Instead, the perverted corporate governance structures that were the consequence of relationship investing and lending without the proper checks and balances in place led many companies to insolvency and brought Japan's financial system close to a collapse.

1996-2003

The Accounting Standards for Financial Instruments (ASFI) issued by the BADC in 1999, established fair value as the valuation basis for financial instruments. Holding gains or losses on securities for trading purposes shall be included in net income for the period. (ASFI No. 3-2-1) Financial instruments that are held to maturity shall be valued at amortised cost. (ASFI No. 3-2-2) Stocks of subsidiaries or associated companies are to be valued at cost price (ASFI No. 3-2-3), but written down in case of a significant drop in value that is not expected to recover. (ASFI No. 3-2-6) Other securities are to be stated at fair value. Holding gains and losses shall be calculated according to the *araikae* method[116] and shall be directly recorded in a separate part of the equity section of the balance sheet after adjustment for the tax effect. However, a second method is allowed according to which holding gains are recorded in the equity section of the balance sheet after deduction of a deferred tax liability like under the first method, but losses go into the computation of net profits for the period. (ASFI No. 3-2-4)

Revaluation of land holdings was temporarily allowed under the Law Pertaining to the Revaluation of Land[117], so that financial institutions and

[115] This is in fact how oil companies tried to cope with rising oil prices during the first and second oil shocks. See: Ono (1996), Chapter 2.

[116] Calculation of the valuation gain or loss according to the *araikae* method (洗い替え方式) means that the current price at the time of a possible recovery shall be compared to the original cost price at the time of initial valuation rather than with the price of the first write-down.

[117] (土地の再評価に関する法律) The MOJ established this temporary law on March 31, 1998 and it was effective immediately for a period of four years.

companies could boost their shareholders equity. A maximum of two thirds of the revaluation reserve could be used to purchase treasury stock (Takeda, 2003, p. 499; Katagi, 2003, p. 86). The CC had not allowed revaluation reserves since 1962. Therefore, the new revaluation reserves represent a move toward physical/financial capital maintenance, as is in accordance with the international trend.

In sum, after World War II Japan adhered in practice mainly to the money capital maintenance concept and since 1962 this was also the formal stance. The loose interpretation of the lower-of-cost-or-market rule enabled companies and financial institutions to carry investments at cost on their balance sheets where they should have been marked down to market. It must have been simpler for external auditors to condone this optimistic interpretation than to loose a client because of a dispute over what is just or what is lawful.

Since 2000 financial instruments shall be carried at fair value. Holding gains or losses on trading securities go into the computation of net income. Held to maturity financial instruments shall be valued at amortised cost. Stocks of subsidiaries or associated companies in the unconsolidated balance sheet shall still be valued at cost price, and associated companies shall be written down when the market price drops significantly and is not expected to recover. Holding gains on other securities go into a valuation reserve, holding losses are either deducted from the revaluation reserve or are deducted from income for the period.

Temporarily revaluation of land holdings was allowed in order to boost shareholders equity. However, the fact that a maximum of two thirds of this reserve could be used to purchase treasury stock indicates that it is a measure designed to give companies flexibility to deal with their bad loan problems.

3.2.3. Definitions of liabilities and equity, and distribution of income concepts

Related to the approaches to determining what profits for distribution are, is the question who should be the beneficiary of a company's profits. At the one end of the spectre there is the proprietary theory, according to which shareholders are the owners of the company and are therefore entitled to the company's net assets including its profits. At the other end there is the entity theory, also called the stakeholder concept, which assumes that there is no difference between liabilities and owners' equity and thus creditors, shareholders and even company employees can receive the profits (Schroeder, Clark and Cathey, 2001, p. 305).

In section 3.1.3., we have seen that from the perspective of creditor protection legal reserves are instrumental in the determination of distributable income under the CC (Art. 290). What constitutes net worth depends on the definitions of liabilities and equity. Furthermore income distribution concepts define which items are shown as expenses or as profits for distribution. A Japanese conceptual framework has only been developed in 2004. In the period before that one has to look for clues to the definitions adhered to on an item-by-item basis.

For example, does an accounting system treat subsidies, donations by

third parties or shareholders, wholly or partially pardoned debt as liabilities, equity or neither? If they are treated as liabilities or as a separate non-liabilities/non-equity group it indicates an inclination towards the entity theory. On the other hand, inclusion in the equity section shows adherence to the proprietary theory. Another question would be whether interest payments, employee remunerations, or tax expenditures appear in the profit and loss statement as income for distribution, or are they regarded as expenses? The former case indicates the entity concept of income distribution, whereas the latter signifies the proprietary concept.

1868-1945

Although both theories were only formalised in the 1920s[118], profits seem to have been distributed based on the proprietary theory in the early period. According to Sakurai, the proprietary concept formed the basis for the Commercial Code and the Corporate Income Tax Law after World War II. Government grants and other amounts donated by non-shareholders were regarded as profit reserve rather than as capital reserve (Sakurai, 2001, p. 1716-1717). In 1934 the Financial Management Committee of the Temporary Industrial Rationalisation Bureau in the Ministry of Commerce issued the Working Rules for Financial Statements[119]. Rule number 39 of the rules pertaining to the inventory states that in order to arrive at net worth (*junzaisan*) one should subtract the amount of debt from the amount of total assets (Arai, 1989, p. 51). This seems to indicate the proprietary concept. On the other hand, directors' bonuses are regarded as distribution of income (Arai, 1989, p. 62).

When the Japanese government started to favour the munitions industry after 1937 the actual distribution of profits was more towards employees than shareholders. Therefore one can say that at least during the war-time economy, in reality the entity concept which is related to the stakeholder concept of corporate governance ruled the distribution of profits.

1945-1980

After World War II the proprietary theory formed the basis for the CC and tax laws, but the entity concept formed the basis for the Business Accounting Principles (BAP) and the SEL. That is to say, the BAP considered funds contributed by other parties than shareholders as "other capital surplus"[120] rather than as earned surplus as was the stance of the CC and tax laws. The latter two considered only paid-in capital as the capital that should be maintained (Takeda, 2003, p. 509-510). Examples of these funds are donations, subsidies or pardoned debt. The reason that the BAP adhered to the entity concept is that it was modelled on US law.

In 1974 the BAP were amended to harmonise its principles with the CC. BAP Annotation no.2-2 stipulates that items until then had resided under capital surplus, but that are not in conformity with the CC's definition of capital shall fall

[118] Paton (1922), p.73, described the entity theory, and Hatfield (1927), p.171, 122, described the proprietary theory.
[119] 財務諸表準則
[120] その他の資本剰余金

under “other retained earnings”. Art.65 of the Financial Statement Regulations[121] stipulated the line items to be disclosed under “other retained earnings” (Takeda, 2003, p. 510-511). Notwithstanding the above director’s bonuses were still considered a distribution of profits. For assets bought with government subsidies etc. companies could also choose to disclose the value of such assets reduced by the amount of the subsidy (BAP Annotation no.24).

Actual dividend payout practices during this period indicated an inclination toward the entity concept of profits. Dividends were generally low because the aim was to pay dividends of five yen per share. The main bank system and mutual shareholdings enabled the development of a situation where debt repayments and retained earnings for internal financing were considered more important than dividend payments. In other words, the interests of creditors and employees dominated in the process of determination of distributable earnings (Ito, 1998, p. 205). This could be considered an expression of the stakeholder concept of corporate governance.

1980-1996

Over this period the official accounting approach to the distribution of profits did not change. Dividends payable as a percentage of shareholders equity was 4.46 percent in 1975, 3.82, 2.90, 2.24, 1.81 percent in 1980, 1985, 1990 and 1995 respectively (Sugino, 1998, p. 133). However, towards the end of the 1980s the stakeholder concept of corporate governance started to show signs of strain under the influence of internationalisation of capital markets as the percentage of foreign shareholders increased.

1996-2003

The official accounting approach to the distribution of profits remained the same; the proprietary concept. Although in the previous periods the actual dividend payout behaviour tended more toward the stakeholder concept, the 2001 amendment to the CC reduced the extent of dividend restrictions. Since 2001 a maximum of one half of the share issuing price can be added to the capital reserve. In addition, the legal reserve consisting of the total of the profit and capital reserves can be a maximum of one fourth of total capital stock (2001 CC Art. 288). Hitherto there had been no maximum for the capital reserve, and the maximum for the profit reserve alone was one fourth of total capital stock (Takeda, 2003, p. 504-505). This can be understood as a step away from creditor protection (see section 3.1.3.) and toward the shareholder governance model. For corporate governance developments in this area see Chapter 2, section 2.5.

In sum, the Commercial Code has officially always adopted the proprietary approach to definitions of equity, liability and the distribution of income. Since 1938 practice moved toward the entity concept under the influence of the stakeholder concept of corporate governance that was advocated by the government. After the War the BAP and the SEL followed the entity concept as it was imported from the US, but adopted the proprietary

[121] 財務諸表等規則

concept in 1974 as a reconciliatory concession to the CC. Explicit limits to dividend payouts since 1950 for the purpose of creditor protection as well as corporate governance practices ensured ever decreasing dividend payout ratios. The 2001 amendment to the CC effectively mitigated the effect of dividend restrictions. Shareholders are now in a better than ever position to receive dividends, if only companies would turn profitable again.

3.2.4. Clean and dirty surplus concepts

According to the all-inclusive (clean surplus) concept of profit, net profits for the period are calculated based on recurrent and non-recurrent transactions and events. In case of the operating concept of profit, net profits are shown only on the basis of operating or recurrent transactions and events. Non-recurrent profits or losses result in increase or decrease of equity respectively, which are shown in a surplus statement.

1868-1945
In accordance with its purpose to determine profits for distribution, the CC embraced the all-inclusive concept of profits. This approach fit well with the narrow interpretation of equity. Note that in the late 19th century the current-operating concept of profits had not yet been developed.

1945-1980
At their establishment, the BAP and the Financial Statement Regulations (FSR) adopted the current operating perspective to the determination of profits to be shown in the profits and loss statement. The purpose of this perspective is to give insight into the performance of a company's management. So until the amendment of the BAP and FSR in 1974, there existed two different concepts side by side. When the CC introduced the rule that large companies had to be audited by an independent accounting firm or CPA, the BAP and FSR were amended to unify the audit systems under the CC and the SEL. One aspect of this attempt at unification was the adoption of the all-inclusive concept of profits (Ito, 1998, p. 210).

1980-1996
Both the CC and the BAP/SEL followed the all-inclusive concept. During this period there were no major developments in this area in Japan. In the US, the FASB released its *Statement of Financial Accounting Concepts* "Recognition and Measurement in Financial Statements of Business Enterprises" in 1984. In an attempt to broaden the scope of measurement of operating income the FASB introduced the definition of "comprehensive income" (Schroeder, Clark and Cathey, 2001, p. 111).

1996-2003
Since December 1997 SFAS No.130 required the reporting of comprehensive income with the same prominence as other financial statements. A net disclosure technique is required for minimum pension liability adjustments, and a

gross disclosure technique is required for other items of comprehensive income (Schroeder, Clark and Cathey, 2001, p. 117). In Japan only the companies that issue their consolidated financial statements in accordance with US-gaap disclose comprehensive income.

IAS 108 regulates disclosure of comprehensive income. Because the EU has adopted IFRS per January 2005 and will require foreign (including Japanese) companies to report their financial statements in accordance with IFRS from 2007, we are presently witnessing a fairly heated debate in Japan about comprehensive income, recycling equity items into profits or losses, and fair value accounting.

A quote from the Keidanren website illustrates the Japanese stance: “Even if considered from the perspective that the value of information on comprehensive income is extremely high, according to current Japanese standards, the items of comprehensive income, including changes in the fair value of financial instruments and the foreign exchange adjustment account, are included in the shareholders' equity section of the balance sheet. It is therefore possible for users of financial statements to obtain information on comprehensive income. In addition, if recycling is prohibited, information on net income based on the realization concept would not be available, thus making it impossible to measure income resulting from the cost of a company's investment.”[122] In January of 2005 the IASB and the Accounting Standards Board of Japan have agreed to embark on a convergence project.

In sum, the Commercial Code followed the all-inclusive concept of profit in the pre-war period. Inconsistency between the BAP and the CC arose because the BAP introduced the current-operating concept of profits to Japan. Since 1974 the BAP and SEL also adopted the all-inclusive concept. Japanese businesses seem reluctant to disclose comprehensive income even though recent accounting standards for investments, financial instruments, treasury stock and mergers would make disclosure valuable information for investors. This reluctance is made clear by the above mentioned statement by the Keidanren.

[122] Nippon Keidanren (Japanese Business Federation), (October 2003), *Seeking International Collaboration on Accounting Standards*, http://www.keidanren.or.jp/english/policy/2003/096/proposal.html

3.3. Accounting standards and regulations in response to internationalisation

1868-1945

"Bank Bookkeeping Methods" was a document issued by the Ministry of Finance in 1873 because in that year the First National Bank was established. Together with Fukuzawa Yukichi's "Methods of Bookkeeping" it introduced the principles of double entry bookkeeping into Japan. Joint stock corporations were established on the basis of the Commercial Code (CC) since 1890, and had to present their financial statements to their shareholders accordingly.

The requirements of the CC lacked detailed prescriptions for the preparation of financial reports. The Business Operation Tax law (1896) and later the Business Operation Income Tax Law (1926) provided some additional guidance. Very detailed provisions came in 1934 with the Working Rules for Financial Statements by the Ministry of Commerce and Industry. These were part of a rationalisation effort following the crisis years of the late 1920s and were not codified.

During the war with China and later the Pacific War, accounting standards came in the form of special taxation measures (since 1937) or as detailed cost estimation standards favouring munitions industries.

The Japanese Commercial Code was based on the German Commercial Code. Karl Friedrich Hermann Roesler [123] drafted the old Commercial Code in 1890. The parts concerning companies, bills and bankruptcies were implemented in 1893, the other parts following in 1898, to be replaced by the new Commercial Code in 1899. The old Commercial Code had been considered too foreign and disregarded Japanese customs of business practise (Fujita, 1991, p. 43).

Articles 190 to 193 of the new Commercial Code covered the accounting matters. Art. 190 required the preparation and submission of an inventory of assets (*zaisan mokuroku*), a balance sheet (*taishaku taishouhyou*), a business report (*eigyou houkokusho*), an income statement (*son-eki keisansho*), and a proposal for income appropriation (*junbikin oyobi ri-eki mata wa risoku no haitou ni kansuru gian*) to the statutory auditors before the day of the general shareholders meeting.

Deposit of the above mentioned financial statements plus a statutory auditor's report, at the company office before the day of the shareholders meeting was mandated by Art. 191. Art. 192 required approval of the financial statements by the general shareholders meeting and publication in a gazette. Finally Art. 193 stipulated that upon approval by the general shareholders meeting, the company would be deemed to have released the statutory auditors and directors from their responsibility (Sakurai, 2001, p.1695). 1899 CC Art.26 stipulated valuation at current cost, and 1911 CC Art.26 says valuation at no higher than current cost.

One important aspect of Roesler's draft that remains a characteristic of

[123] Roesler had also been involved in drafting the Constitution, which was based on the Prussian model.

the Japanese accountability system until today, is the relationship between the board of directors, the statutory auditors and the general shareholders meeting (Motoki, 1999, p. 93-94). Both the statutory auditors and the directors are appointed by the general shareholders meeting, who can also discharge them before their term expires.

1945-1980

The Securities and Exchange Law (SEL) was issued in a hurry in 1947, and amended in 1948 in order to facilitate the reopening of the stock exchanges in accordance with GHQ conditions. In the following year the Business Accounting System Measures Investigating Committee issued the Business Accounting Principles (BAP)[124] and the Working Rules for Financial Statements (WRFS). As these were not laws, they had to be made into enforceable law. The Business Accounting Deliberation Committee (BADC) incorporated the standards into the Financial Statement Regulations (FSR) in 1950.

Art.193 of the SEL requires companies to prepare financial statements in accordance with the FSR, have them audited by an independent CPA or audit firm (SEL Art.193-2), and present them included in the securities report to the Securities and Exchange Commission (to the Minister of Finance after 1952) within three months after the closing of the business year (SEL Art.24).[125] In 1950 the FSR required publicly traded companies to prepare a balance sheet, profit and loss statement, a surplus statement and a surplus appropriation statement, plus supporting schedules (FSR Art.1). The formats were fixed according to the FSR Formats[126].

Measurement standards do not exist in the FSR. The FSR are concerned with the terminology, formats and preparation methods of financial statements. Valuation and measurement of assets and liabilities are stipulated by the BAP. However, as these have no legal status, measurement under the SEL is actually ruled by the CC.

From 1950 to 1962 there was confusion on this point because the BAP that were supposed to be a reference point for the CC and SEL alike differed from the CC with regard to valuation (see section 2.4.). The BADC claimed that because the BAP are a summary of the gist of generally accepted accounting practices and customs, companies should follow its principles even if the BAP is not enforced by law.[127] In reality it was a document motivated by aspiration and ideals. At the time there was no such thing in Japan as generally accepted accounting practices and customs. Furthermore, the BAP introduced the concept of a surplus that was divided in earned surplus and capital surplus. In

[124] This is a document similar to “A Statement of Accounting Principles” by Sanders, Hatfield and Moore in 1938. However, in the Japanese case there was no mentioning of consolidated financial statements. Fujita (1991), p. 138.

[125] Other occasions where the MOF requires financial statements to be presented are at the registration of a company’s stock or in the prospectus when a company plans to issue new shares, or in the case of a change in listing status.

[126] 財務諸表等規則様式

[127] Business Accounting System Measures Investigation Committee (July 9, 1949) *企業会計原則の設定について (Regarding the Establishment of the Business Accounting Principles)*, point number 2.

addition the Working Rules for Financial Statements required supporting schedules which were also a first in Japan (Chen, 1999, p. 10-11 quoting Kurosawa 1959, p. 280).

In the same year the CC was amended to make a distinction in the balance sheet between capital and earned surplus in order to adopt a financial capital maintenance stance like that of the SEL. The CC also recognised the costs of new share issues as deferred charges (see section 2.4.1.). 1950 was also the year when the BADC issued the Audit Standards and the Working Rules for Performing Audits, which were both again revised in 1956. Because there were many doubts about how to interpret the BAP and the FSR, the BADC issued the Annotations to the BAP in 1954.

1962 saw the BADC issue the Cost Estimation Standards. This was also the year of the first major amendment to the CC as a step to unify both accounting systems. The CC adopted accrual accounting by allowing the use of specific provisions and extended the scope of deferred assets to a total of eight items. Valuation at historical cost basis became the norm, and the inventory of assets was no longer required. In addition, the CC explicitly stipulated the calculation of the maximum amount that could be paid out as dividends. Since then it was very clear that the CC was the main law in the Japanese financial accounting system.

Under the FSR a surplus statement had been required since 1950. In 1963, the BAP and FSR were amended so that the word “surplus statement” was now replaced by “earned surplus statement” more commonly called “retained earnings statement”. Instead of preparing a separate earned surplus statement, companies were allowed to combine the earned surplus statement with the profit and loss statement (Chen, 1999, p. 52).

The 1974 revision of the CC was meant to bring the audit system in line with the requirements of the SEL. Thus since 1974, the CC requires large joint stock corporations that have their financial statements audited by an independent audit company or CPA under the SEL, to do the same for its financial statements under the CC. As a compromise toward the CC, the BAP changes from the entity concept to the proprietary concept with regard to the distribution of profits. For the profit and loss statement, the BAP also moves toward the CC by adopting the all-inclusive concept of profits.

Then, in 1976 the BADC issues the Consolidated Financial Statement Regulations (C-FSR) which are effective from 1978 and give consolidated financial statements secondary status, followed by the Interim Financial Statement Regulations (I-FSR) in 1977, effective from 1979. Under the C-FSR companies are required to prepare a consolidated balance sheet, profit and loss statement, statement of retained earnings which may also be combined with the profit and loss statement.

As the Bretton-Woods system had broken down in 1971, and two oil shocks had taken place in 1973 and 1978, the BADC’s Accounting Standards for Transactions in Foreign Currencies came just in time to accommodate the Foreign Exchange Law of 1980 which largely deregulated foreign exchange transactions.

1980-1996

In 1981 the CC was amended to clarify the use of provisions, and to address the problem of the par-value stock system hollowing out (see section 2.4.2.). From 1983, the FSR requires the adoption of the equity method for unconsolidated subsidiaries. The BADC issued an Opinion of the Disclosure of Segment Information in 1988. Its Opinion became effective as of 1991 but adoption was voluntary until 1993. From 1994 to 1997 disclosure of segment information became mandatory in three steps.

Between 1989 and 1990 the US and Japan held bilateral talks to solve trade and other disputes within the framework of the Structural Impediments Initiative. From the US side there were, among others, demands for increased financial disclosure standards and strengthening the rights of shareholders. As a consequence of which related party disclosures were introduced in 1992. Segmental disclosures are sometimes thought to have been a result of the talks, but the Opinion on Segment Disclosures had already been issued in 1988, and took nine years to be fully implemented. Segment disclosure applied to consolidated financial statements only, and its format is fixed.

The BADC Opinon on Accounting for Lease Transactions established the rule that a lease is a financial lease only when the ownership title is transferred to the lessee. All other leases were to be accounted for as operating leases. The Opinion was effective from the year ending March 1995. Under the CC financial leases are accounted for in the same way. The JICPA made a format to present an overview of the lease assets.

1996-2003

As Prime Minister Hashimoto announced the financial big bang in 1996, it seemed like the economy was on its way to recovery. However, in 1997 and 1998 the financial system was in a precarious situation to an extent that it had never been before (see section 2.6.4.). Financial institutions in particular needed to get rid of bad loans and carry out reforms in order to guarantee their survival. To that purpose tax effect accounting and further relaxation of restrictions of the purchase of treasury stock were introduced. Together with the relaxation of the Anti-monopoly Law this enabled financial institutions to establish holding companies.

The introduction of consolidated cash flow statements, making consolidated financial statements the primary financial statements under the SEL, introducing fair value accounting for financial instruments and some types of securities were aimed at increasing management of company groups as a whole, and at unravelling cross-shareholdings. Changing the scope of consolidation to the basis of real control instead of control based on shareholdings was a measure meant to end the practice of passing on losses to unconsolidated subsidiaries or associated companies. Consolidated financial statements were also required under the CC from the companies that already had to produce them under the SEL. These companies could also opt for taxation on a consolidated basis.

Accounting standards for retirement benefits were also part of the accounting big bang and had been long due. With pension reserves being an

estimated 14 trillion yen short (Fujii, 2002, p. 95-96), this had been a particular area that made it hard for investors to assess company performance and risk. Accounting standards for asset impairment were issued in 2002, and were the last project carried out by the BADC. Asset impairment accounting starts to apply in 2007.

Amendments to the CC in 2002 and 2003 enabled companies to choose a corporate governance structure that resembles the US model. It also tried to increase the number and influence of outside directors in the companies that choose to stick with the Japanese model.

The establishment of a private sector accounting standard regulatory body (the Accounting Standards Board of Japan) in July of 2001 marked a departure from Japan's historical legacy as a code law country. However, in reality we will have to see how new accounting standards are developed and adhered to. Because the public is not used to self-regulation it may be interesting to see how corporate managers and directors perceive their responsibility to disclosure information.

Although most of the accounting regulations under the CC have been moved to Commercial Code Enforcement Regulations in 2003, accounting standards under the CC still need to be endorsed by the Ministry of Justice if no longer by the Diet. Furthermore, the laws that are already in place are not likely to soon be replaced by a regulatory framework on private footing.

3.4. Conclusions for Part 1

In sum, the Commercial Code as the basis of all accounting regulation in Japan owes its very existence to Japan's attempt to catch up with the West. Her accounting system's development clearly followed the macro-economic pattern commensurate with the code-law nature of her legal system. Especially after World War II both the code-law legal system and Japan's Ministry of Finance favoured creditors over shareholders and arms-length investors in order to build up Japan's economy. The Securities and Exchange Law and the Business Accounting Principles were meant to democratise capital markets. However, faced with neglect by the Ministry of Finance and a financial system biased toward bank financing and the fact that its rules did not have any legal meaning, the Business Accounting Principles were temporarily reduced to relative insignificance in 1962.

The definite settlement of accounts principle and the newly introduced specific provisions ensured that the determination of distributable income which is the purpose of the CC accounting standards actually minimised taxable income as well as income for distribution. Lacking transparency and strong independent auditing function, already in the early 1960s window dressing had become rampant. After more than ten years, in 1974 did the Commercial Code introduce independent auditing, but only for companies that already were subject to independent auditing under the SEL. Late introduction of consolidated financial statements and their secondary status are another example of the clout of the business community and the lack of political power of shareholders. It is very clear that when Japan's capital and financial markets were closed off and

protected by heavy regulation, financial accounting system development was characterised by political influence from macro-economic planners and business managers. Accounting academia spent most of their time pondering unification of accounting under the CC and SEL systems.

Since exports were important to Japanese companies, inevitably Japan's financial and capital markets slowly opened up and were even more gradually deregulated. The 1980s were a golden age for Japan's economy and businesses. Companies could venture overseas and do all the things they were not allowed to do at home. For Japan's accounting system the 1980s were a time when very little happened. Independent audit requirements centred on the relatively few listed companies, the public sector did not use independent auditors, so the number of CPAs was kept as low as possible. Statutory auditors did not necessarily have any knowledge of accounting, and management accounting practices were very much a product of in-company training (Sakagami, Yoshimi and Okano, 1999, p. 350-351). The hierarchical structure in Japan's universities caused the majority of accounting professors in the 1980s to be of the generation who had diligently studied the German language and the German accounting system of the early 20th century. Younger scholars did study the American accounting system, but at the time they were too junior to be influential. The regulators of the Ministry of Justice held on to the legal entity concept, and the BADC did not spontaneously issue standards. Overall the system produced very few people who recognised the growing influence of the international market and acted upon it.

International political pressure for transparency in the second half of the 1980s yielded little result. At the time the booming stock market attracted many speculative investors. Bullish markets made everybody look like a successful and knowledgeable investor or financial engineer. When the boom got busted and the bull turned bearish regulators and investors alike hoped for an eventual market recovery. By not taking action the situation actually worsened to the point where a number of banks and securities companies collapsed under their bad loan burden and international rating agencies downgraded Japanese government bonds.

No longer able to bail out failing companies without loosing credibility under the watchful eyes of the international financial community, Japan's government decided on far-reaching reform. The financial system was deregulated, the power of the MOF curtailed, and the international market forces were finally allowed to play their part in the market for financial information disclosure. International market forces are felt strongest by those companies operating in and dependent on the international market for resources.

The privately funded ASBJ replaced the publicly funded BADC as the body to set accounting standards. Nevertheless, Japan firmly remains a code-law country. Therefore, the accounting standards issued by the ASBJ will have to function in the framework that is constituted by both the Commercial Code and the Securities and Exchange Law. This means that the views of the company as a legal entity and an economic entity will have to co-exist within the same accounting system. Since the definite settlement of accounts principle no longer universally applies there is a better chance that presenting a fair picture of

companies' performance and financial situation will lead to increased decision-usefulness of accounting information in the financial statements. However, the main purpose of accounting under the Commercial Code is still reconciling stakeholders' interests. As we have seen in sections 3.1.3. and 3.2.3. protection of creditors' interests is no longer as prevalent as it used to be. Explicit dividend restrictions still exist but have a much higher ceiling.

As for the distribution of income concept adhered to, the move toward the shareholder governance model indicates a good chance that it will be the proprietary concept in name and in practice. Primary status for consolidated financial statements is another sign that the economic entity concept now has a firm place in Japan's accounting system and perhaps in Japan's society too. More disclosure in consolidated financial statements and transparency of corporate governance structures are good for shareholders and investors as well as creditors.

Independent auditing is going to take up a more important place in Japan's accounting system. The number op CPAs is expected to increase drastically as requirements have been changed and thresholds lowered. I am hopeful that an increasing number of CPAs will value the benefits of professional integrity higher than the costs of possibly antagonising superiors or customers. Japanese culture does not encourage independence, open criticism or disharmony in professional dealings or private relationships. However, if the accounting system is changing because of international market forces and resource dependency, Zarzeski (1996, p. 35) may be right to think that even culture could change under the same influences.

Chapter 4: The US and Japan's Financial Accounting Systems

4.0. Introduction

Part 1 presented an inquiry into how Japan's accounting system has responded to the demands of a changing international business environment. We found that national paradigms spurred on by international political factors influenced Japan's accounting development from 1868 to 1980 more than anything else. The choice for a macro-economic oriented pattern of accounting development seems therefore appropriate. From 1980 until 1996 the national political influence of businesses dominated accounting development, or rather the lack of it. At the same time, international market forces were at work bringing about gradual deregulation of financial and capital markets. These forces pushed financial accounting standards development in Japan into a more micro-economic pattern from 1996 onward. As a result we find more standards that support the economic entity concept of companies that stresses disclosure of useful information to investors and shareholders, where hitherto the legal entity concept had ensured a high level of creditor protection. Furthermore, since 2001 Japan has a private accounting standard setting body that functions alongside and within the code-law legal system.

Against this background of greatly improved financial accounting and disclosure standards, Part 2 seeks to answer the questions: "Has internationalisation of business, financial and capital markets brought about convergence of financial accounting and disclosure standards between US-GAAP and JP-GAAP? In what ways and to what extent has convergence come about?" Chapter 4 seeks to analyse the differences and similarities of both accounting systems, and Chapter 5 focuses on comparison of the consolidated disclosure systems. Paragraphs 4.1.1., 4.1.2., and 4.1.3. compare the development patterns of the US and Japanese financial accounting systems with regard to the environmental factors and functions of accounting regulation and

information. Characteristics of the US and Japanese accounting systems are compared in paragraphs 4.1.4. and their accounting concepts are compared in 4.1.5. Recognition and measurement standards form the topic of comparison between both countries in Section 4.2. Recognition and measurement standards for consolidated and unconsolidated financial statements are the same because consolidated financial statements are prepared using the unconsolidated financial statements. It is in presentation and disclosure where the differences between unconsolidated and consolidated financial statements arise.

Chapter 5 is concerned solely with comparison of the standards for disclosure in consolidated financial statements under US-GAAP and JP-GAAP. This comparison is not necessarily exhaustive, but is conducted with reference to the research problems of this dissertation. It therefore seeks to analyse and eventually quantify the difference in disclosure requirements in consolidated financial statements according to US-GAAP and JP-GAAP. In cases where Japanese consolidated disclosure requirements do not exist but unconsolidated requirements do exist these shall be mentioned. These cases serve to illustrate the secondary nature of consolidated financial statements in Japan and at the same time to indicate that unconsolidated disclosure requirements were extensive.

Matrix 2 will aid reading through chapters 4 and 5. As there are still differences in accounting and disclosure requirements of both systems, these too will be addressed in chapter 5. Finally in chapter 5, matrix 2 will be converted into the disclosure sheet that I used to measure voluntary disclosure between 1985 and 2003 for the fifty-two sample companies that constitute the population for the empirical study in chapter 6. A summary and the conclusions for Part 2 will be found in chapter 5.

4.1. Comparison of the accounting concepts and approaches, and the functions of accounting standards in Japan and the US

4.1.1. Brief outline of the US accounting system

By the 19th century, bookkeeping expanded into accounting because ongoing business organisations increasingly replaced isolated ventures. The notion emerged that the owner's original contribution plus profits or minus losses indicated net worth. Concepts of cost and income and capital maintenance had not yet been developed, but the emergence of joint stock corporations created the need to distinguish between capital and income. These developments took place mainly in Europe, but in the second part of the 19th century, the Industrial Revolution arrived in the US and brought with it the need for formal accounting procedures and standards. At the time, anyone could claim to be an accountant, stock markets were a place for speculation, and large monopolies controlled segments of the US economy. Corporate abuses contributed to the need for development of financial and later physical capital maintenance concepts. At the International Congress of Accountants in 1904 the American Association of Public Accountants was formed, which was in 1916 reorganised into the American Institute of Accountants (AIA). Accounting practice during the 1920s is said to have placed too much emphasis on the needs of management, as a

consequence of which the stock market crashed in 1929 (Schroeder, Clark and Cathey, 2001, p. 3-5).

In the USA the stock market crash of 1929 led to the establishment of the Securities and Exchange Commission (SEC) by the Congress in 1933. This event can be regarded as a watershed in US business and accounting practice. Before the SEC established its rules, maintaining standards of good accounting practice had been a matter of individual discretion. After, accounting principles applied to companies listed on stock exchanges still allowed freedom of choice, but emphasised disclosure of accounting practices in order to increase transparency and usefulness of accounting numbers.

The American Institute of Certified Public Accountants (AICPA), or actually its predecessor the AIA, had started working with the New York Stock Exchange (NYSE) to issue accounting principles and pronouncements in 1930. After intense debate the SEC delegated its authority to establish US Generally Accepted Accounting Principles (US GAAP) to the AIA. But it had the final say in deciding accounting practice by refusing company accounts that deemed to be of lesser quality.[128] If ever there was a time when US accounting standards could have been set by public regulators, this was it. Although the idea was to develop a theoretical framework of accounting, the general view in 1937 was that if accountants did not come up with a coherent set of rules the SEC would. The AIA somewhat hurriedly published a study by Sanders, Hatfield, and Moore called *A Statement of Accounting Principles*. As this was simply a survey of existing accounting practice, it was quite controversial (Schroeder, Clark and Cathey, 2001, p. 6). Nevertheless, it also provided the authoritative source on which the Japanese Business Accounting Principles (BAP) were based (Matsui, 1998, p. 29).

Accrual accounting was advocated by Paton and Littleton in 1940 as superior to cash-based accounting (Beaver, 1998, p. 2). Under this approach, which is similar to Eugen Schmalenbach's dynamische Bilanz approach, the balance sheet serves as a transitory tool to match revenues and expenditures in the profit and loss statement. Since then much effort has been spent on deciding which accrual method is best.

In 1937 the AIA and the American Society of Certified Public Accountants merged to form the American Institute of Certified Public Accountants (AICPA). Pronouncements in the form of *Accounting Research Bulletins* (ARB) were issued by the AICPA's Committee on Accounting Procedure and formed the first generally accepted accounting principles (GAAP). The AICPA formed the Accounting Principles Board (APB) in 1959. In issuing Accounting Research Bulletin (ARB) No. 43, it revised and incorporated all previous ARBs. Criticism from the SEC did not wane, and in 1972 the Financial Accounting Standards Board (FASB) was established. Members of the FASB included accountants as well as representatives from other interest parties, whereas the APB had consisted of accountants only.

In the USA there is only one financial accounting system, and consolidated financial statements are the rule. Only companies that have no

[128] For a history of the development of the US accounting system see Fisher *et al*. (2001), p. 2861-2871, or Roberts, Weetman and Gordon (1998), p. 455-456.

subsidiaries issue unconsolidated financial statements. There are no laws regulating the publication of consolidated or unconsolidated financial statements. US-GAAP, embodied in ARB43 and ARB51, Accounting Principles Board (APB) Opinions, and the Statements of Financial Accounting Standards issued by the FASB, are the product of private sector regulatory activities.

Before the establishment of the Consolidated Financial Statement Regulations in Japan in 1976, the following accounting standards related to the consolidation of financial statements in the US had already been issued.

(June 1953) AIA, ARB43: *Restatement and revision of Accounting Research Bulletins*
(August 1959) AICPA, ARB51: *Consolidated Financial Statements*
(December 1966) AICPA, APB10: *Omnibus Opinion-1966*
(August 1970) AICPA, APB16: *Business Combinations*
(August 1970) AICPA, APB17: *Intangible Assets*
(March 1971) AICPA, APB18: *The Equity Method of Accounting for Investments in Common Stock*

ARB43 set rules for the accounting treatment of businesses in foreign countries and foreign currency translations (Ch.12). ARB51 explained the purpose of consolidation, and provided guidelines for the consolidation process. APB10 amended ARB51 in that it made mandatory the equity method for unconsolidated subsidiaries within the US. APB16 provided the standards for the use of the purchase method and the pooling of interests method for business combinations. APB17 stipulated amortisation of goodwill. APB18 dealt with the application, accounting treatment and disclosure of the equity method (Nomura, 1999, p. 58-59).

The phrase “generally accepted accounting principles” became part of the wording of the certificate issued by CPAs. Therefore *Statement on Auditing Standards (SAS) No. 5* was issued in 1975 to clarify what it meant that financial statements are “fairly presented in accordance with generally accepted accounting standards”. SAS No. 5 was followed by SAS No. 43, and later amended by SAS No. 69. US-GAAP consists of four levels of sources of which the highest are FASB Statements, FASB Announcements, SEC Rules and Interpretive Releases and the old APB and ARB unless they have been amended (Schroeder, Clark and Cathey, 2001, p. 15-16).

Portfolio diversification had been common practice even before the development of portfolio theory started by Markowitz in 1952. However, with the advent of capital asset pricing theory around 1965 investors gained important tools for constructing portfolios in accordance with their risk preferences. Since it had proven very hard to establish consensus on the best measurement and reporting methods, the emphasis shifted from economic income measurement to providing information that is useful for investors to base their decisions on. This is demonstrated by the FASB’s *Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises* (SFAC 1) in 1978 (Beaver, 1998, p. 4). The instrumental role of information in market efficiency as documented in the pricing of pension assets and obligations, fair value of investment securities and financial instruments, and nonperforming loans (Beaver, 1998, p. 135) gave regulators a motive to raise disclosure standards.

In other words, in 1978 the FASB's Conceptual Framework project of which SFAC 1 was the first of seven pronouncements, adopted a decision-usefulness approach. That is, as summarised by Kieso and Weygandt, "The objectives of financial reporting are to provide information that is: (1) useful to those making investment and credit decisions who have a reasonable understanding of business and economic activities; (2) helpful to present potential investors, creditors, and other users in assessing the amounts, timing and uncertainty of future cash flows; and (3) about economic resources, the claims to those resources, and the changes in them" (Kieso and Weygandt, 1998, p. 36). Inherently problematic is the fact that historical-cost-based financial statements have to be used to predict future returns. In order to help investors predict future returns, information has to be relevant and reliable, as was the gist of a *Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information* (SFAC 2) issued in May 1980 (Scott, 1997, p. 148-159). "For information to be relevant, it should have predictive or feedback value, and it must be presented on a timely basis. (…) Accounting information is reliable to the extent that it is verifiable, is a faithful representation, and is reasonably free of error and bias" (Kieso and Weygandt, 1998, p. 38). In order to be useful, information should be comparable between companies, and be prepared in a consistent manner over time.

Assets, liabilities, equity, investment by owners, distributions to owners, comprehensive income, revenues, expenses, gains and losses were identified as elements of financial statements and defined by the *Statement of Financial Accounting Concepts No. 3: Elements of Financial Statements of Business Enterprises* (SFAC 3) in December of 1980. Already in December 1985 SFAC 3 was superseded by *Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements* (SFAC 6). *Statement of Financial Accounting Concepts No. 5: Recognition and Measurement in Financial Statements of Business Enterprises* (SFAC 5) established recognition and measurement criteria and practical guidance on the topic in December 1984. These criteria are based on the definitions of the elements of financial statements.

In 1984 SFAC 5 concluded that a statement of cash flows should be part of the financial statements. As a result SFAS No. 95 was issued in 1987. Also in the measurement process, in recent years the matching concept emphasises flows, and reports stock as residuals. Put differently, to a certain extent we find a shift away from the income statement approach toward the balance sheet approach again (Schroeder, Clark and Cathey, 2001, p. 139). Examples of current values in financial accounting in the US are; discount amortisation on long-term bonds (APB 21 since 1971), leases (SFAS 13 since 1977), and pension obligations (SFAS 87 since 1986). More recent examples include; postretirement benefits (SFAS 106 since 1990), impaired loans (SFAS 114 since 1993), capital asset impairment accounting (SFAS 121 since 1995), and financial instruments (FSAS 80 since 1984, SFAS 105 since 1990, SFAF 107 since 1992, and SFAS 115 and SFAS 119 since 1994) (Scott, 1997, p. 58-59). These will be discussed in more detail in chapter 5. Within the Conceptual Framework *Statement of Financial Accounting Concepts No. 7: Using Cashflow Information and Present Value in Accounting Measurements* was issued in

February of 2000 in order to provide guidelines on how to deal with problems related to accounting for risk, fair values, and asset impairment.

The Sarbanes-Oxley Act (SOX) of 2002 was established in the wake of the Enron and other scandals. It addresses issues such as auditor independence, corporate responsibility, and increased disclosure of transactions involving management and principal stockholders. Furthermore, it established a Public Company Accounting Oversight Board. SOX may be viewed as a piece of legislation that serves to compensate the failure of the market for information that comes about when information asymmetry causes moral hazard. It remains to be seen how effective these regulations are.

4.1.2. Sources of Japanese consolidated financial accounting standards

Notwithstanding a long history of large company groups starting with *zaibatsu* during the Taisho period (1911-1926) and vertical and horizontal *keiretsu* after World War II, consolidated financial statements only started to emerge from 1960. Companies such as Hitachi and Sony issued them to have their shares traded on the New York Stock Exchange via American Depository Receipt (ADRs). In May 1965, the Minister of Finance ordered the BADC to investigate codification of consolidated financial statements as well as strengthening the audit system after window dressing practices by Sunwave Co. Ltd. and Sanyo Mining Company had led to a chain of bankruptcies in 1964 and 1965 (Kuroda, 2001, p. 1817).

The *Working Rules for Performing Audits* were indeed revised in 1965. Although the BADC issued its *Opinion on Consolidated Financial Statements* (Consolidation Opinion) on May 19, 1967, it stated that consolidated financial statements were new to Japan, and that generally accepted accounting practices with regard to the preparation thereof had to be reinvestigated and formulated in the stage of systemisation (BADC, 1967/05/19). The *Opinion on the Codification of Consolidated Financial Statements* and the *Principles for Consolidated Financial Statements* plus its *Annotations* only followed on June 24, 1975. Actual Codification took place when the MOF issued the Consolidated Financial Statement Regulations on October 30, 1976 (Kuroda, 2001, p. 1818). The system started from the period ending March 31, 1978. In total, the process had taken more than ten years, due to opposition by the business community (*keidanren*) and diversity of opinions within legal and academic communities.

In accordance with the Consolidation Opinion's recommendations, consolidated financial statements were to be presented as supplementary documents to the registration statements or the annual security reports issued by listed companies under the SEL. Shareholders received unconsolidated financial statements based on the Commercial Code (on the basis of which dividends were declared) from the company directly, and were only able to peek into a company's consolidated financial statements about a month after the annual shareholders meeting.

Due to a revision of the Ministerial Ordinance for Registration[129] the

[129] 届出省令

consolidated financial statements had to be submitted at the same time as the Securities Report, and together with the “Important items regarding the situation of the company group” [130] and “Overview of the company group’s performance”[131] altogether under a heading reading “Consolidated Information” from April 1988 onwards. Its supplementary status only changed when due to a revision of the Ministerial Ordinance for Disclosure[132] consolidated financial statements had to be included in the Securities Report itself as of April 1991.

Disclosure requirements were still less extensive than the requirements for unconsolidated financial statements. However, over time the perceived importance of financial information on a consolidated basis increased, as did disclosure requirements. Officially, from 2001, consolidated financial statements are the primary statements whereas the unconsolidated financial statements are secondary. With the scope of consolidation based on effective control rather than the percentage of shares held, the framework is set for company group management. It may take a few years for customs and mindset to fully adapt to this challenge.

Individual financial statements under the SEL are prepared according to the *Financial Statement Regulations* and their *Annotations*. Until 2002, the CC prescribed the measurement and recognition standards. Since then these can be found in the *Commercial Code Enforcement Regulations*, although the BAP provide the foundation for these standards. Furthermore, financial accounting statements shall be prepared in accordance with the new requirements after the accounting big bang. The individual financial statements shall then be consolidated in accordance with the *Principles for Consolidated Financial Statements* and based on the *Consolidated Financial Statement Regulations* (C-FSR). Since the year ending in March 2000, consolidated cash-flow statements shall also be prepared.

In principle, the unconsolidated financial statements of a parent company and its subsidiaries shall be prepared based on the same accounting standards (BADC, 1975, No. 3-3) so that upon consolidation the information presented will be consistent. The JICPA states that no adjustment is necessary when an overseas subsidiary uses a different accounting treatment than its parent company, except when the accounting method is obviously not rational. In that case the reason for adjustment and the amount of the adjustment have to be disclosed in a note (JICPA, 1997).

The *Principles for Consolidated Financial Statements* plus their *Annotations* present the purpose of consolidation, the general accounting principles underlying consolidation, the general standards regarding scope of consolidation, differences in accounting periods, and unity of accounting standards between parent company and subsidiaries, as well as the standards for preparation of the consolidated financial statements. These standards describe the mechanics of consolidation of the balance sheet, the income statement, and the retained earnings statement.

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[130] 企業集団の状況に関する重要な項目

[131] 企業集団の業績の概要

[132] 開示省令

The C-FSR stipulate the terminology, forms, and preparation methods for consolidated financial statements like the FSR do for individual financial statements. For cash-flow statements there are the separate *Standards for the Preparation of Cash-flow Statements.*

4.1.3. Functions of accounting standards in the US and Japan

If accounting is the language of business, differences in accounting standards arise from differences in business practices and environments. The US simply grew to be a common law country because she started out as a British colony, inherited notions of freedom and democracy, and then fought for her own independence. In Japan, the government could have chosen to adopt a common-law system, given the fact that the 1872 National Bank Act was drafted by the Scotsman Alexander Shand. In the 1880s the Japanese government opted for a German type code law system instead, because this suited the purpose of government-led economic development better. Japan had a lot of economic and geo-political catching up to do and was keen on doing so as quickly as possible.

In the US private enterprise was thus mainly financed raising capital through the market. Until the stock market crash in 1929, financial reporting in the US had been without any regulation and was generally an anything goes affair like in most other places at the time. Still in Japan the market still had to be made, trusted and accepted. Quite another problem was the availability of savings. In Japan savings were scarce, which is one reason why initially in the 1870s and 1880s banks issued notes and created inflation. The same problem resurfaced after World War II, and this time a similar solution was found in the shape of the printing presses and special purpose banks, again with inflation as a result.

After the war, the US were the victorious, rich nation, Japan was the defeated, destitute nation. Shareholders in the US were vocal and their rights were perceived to be important. In Japan banks and company directors were very powerful, shareholders were not. Furthermore, every individual was supposed to make sacrifices for the common good, which was to erase the shame of defeat in the Pacific War by attaining economic prosperity. Very soon after World War II, leverage increased, and the percentage of individual shareholders dropped. Although in both countries an important function of accounting standards was to calculate distributable earnings, US companies sought to maximise profits and shareholder value, Japanese companies maximised market share. Unlike in the US where accounting regulation was mainly a private sector affair, during the 1960s and 1970s, the Japanese accounting system served primarily as a tool for macro-economic policies. Application of the definite settlement of accounts principle in combination with taxation measures that stimulated capital investment made sure that Japanese companies had much to gain from minimising profits.

While in the US the FASB issued SFAC 1 in 1978 as part of the Conceptual Framework project, around the same time Japan for the first time introduced consolidated financial statement requirements. A Japanese Conceptual Framework did not materialise until September 24, 2004. At the end

of the 1970s the US can be characterised as a market economy and Japan as an economy in the process of slowly and perhaps somewhat reluctantly shifting from strong regulation to financial deregulation. It is therefore no surprise that since 1978 Japan rapidly fell far behind the US in terms of the quality of the information produced by her financial accounting system. Between 1980 and 1996, when the old paradigm was no longer functioning very well but the new paradigm had not been defined yet, Japanese regulators adopted a piecemeal approach to accounting standard setting. At the same time, in the US many new accounting standards were established in order to deal with the challenges of internationalisation of business, financial and capital markets, new financial instruments, and old problems such as moral hazard.

Opaque corporate governance and financial disclosure systems caused the near collapse of Japan's financial system in the mid-1990s. Japan's financial big bang and the ensuing overhaul of her accounting system were almost complete when the world was demonstrated the shortcomings of corporate governance and audit systems in the US. The Sarbanes-Oxley Act of 2002 is an attempt to address these problems. It seems fair to say that presently in both countries the prime function of financial accounting is to provide useful, reliable, and relevant information for investment and credit decisions.[133] The function of accounting standards both in the US and Japan is therefore to ensure the usefulness, relevance, and reliability of financial accounting information.

4.1.4. Characteristics of the accounting systems in the US and Japan

This section compares some characteristics of the accounting systems in the US and Japan in order to illustrate that different environments produce different accounting systems. Within the timeframe between 1985 and 2005, one can clearly see that internationalisation has induced a movement of the characteristics of the Japanese accounting system to grow more similar to the characteristics of the US accounting system. On the other hand, recently one could detect greater importance attached to public sector involvement in accounting regulation in the US.

Regulatory system

Traditionally, accounting regulation in the US has been a private sector affair. The government only intervened when things went terribly wrong. Thus, the Securities and Exchange Acts of 1933 and 1934, and the Securities and Exchange Commission owe their existence to the stock market crash of 1929 (Scott, 1997, p. 5). More recently, the Sarbanes-Oxley Act of 2002 was a regulatory response to the Enron and other debacles that duped many shareholders, employees and customers.

In Japan on the other hand, accounting regulation was in the hands of the public sector and has only been transferred to the private sector Accounting Standards Board of Japan (ASBJ) in 2002. Until then, formulation of accounting standards under the Securities and Exchange Law (SEL) had been the task of

[133] SFAC No. 1, and the ASBJ Conceptual Framework as described in Kawamura, Yoshinori (2005), p. 60.

the Business Accounting Deliberation Council under the Ministry of Finance. It was then up to the Ministry of Justice whether or not to incorporate these standards into the Commercial Code (CC). As the CC and SEL accounting systems are generally perceived in Japan to have ultimately different purposes, true unification of the systems proved very elusive. However, shifting measurement and other accounting standards from the CC to the *Regulations Pertaining to the Implementation of the Commercial Code* increases the chance that unification of the two accounting systems will be attained.

Purpose of financial statements

As we have seen in section 4.1., in the US the purpose of financial statements was clarified in SFAC 1 in 1978. Financial statements shall provide information that is useful, reliable and relevant for investment, credit and other decisions. The information shall enable its users to assess the amounts, timing and risk of cash-flows, the value of economic resources, and the claims to these resources. There is basically one financial accounting system and the financial statements serve all external users.

In Japan the financial accounting system under the Commercial Code is said to aim at adjustment of the interests of creditors and shareholders. It mainly protects the interests of creditors by means of capital maintenance taking the form of dividend restrictions.[134] Disclosure of information has never been the territory of the CC because financial statements under the CC have traditionally not been widely available. Many companies did not even fulfil the obligation to publish their financial statement under the CC in a gazette, and obviously could get away with it.

The Japanese Securities and Exchange Law (SEL) states its purpose as "to bring about fair floating, trading and other transactions in marketable securities, and smoothen the flow of securities in order to contribute to proper operation of the national economy, and to the protection of investors." (1949 SEL Art. 1) There are those who consider the SEL a special law to the CC, because it possesses the character of a disclosure law.[135] However, as both laws have been established for different purposes and are administrated by different ministries, this seems a convenient explanation of an ad hoc nature. Accounting under the SEL is supposed to be in accordance with the Business Accounting Principles (BAP) which have no legal status, but cannot go against the accounting standards of the CC because these do have legal status.

Creditor and shareholder protection

In the US creditor protection constitutes mainly of legal capital requirements. Generally, creditors are thought to have become increasingly adept at protecting themselves through the use of ratio requirements, compensating balances, bond ratings, loan syndication, close monitoring, and legal enforcement mechanisms. Disclosure of relevant and reliable information is supposed to help investors, shareholders, and creditors make investment and credit decisions.

On the other hand, for most of the post-war period, in Japan creditors

[134] For example: Takeda (2003), p. 19.
[135] For example: Hirose (1998), p. 79.

were thought to need protection against the speculative nature of shareholders and the opportunistic nature of corporate management. Legal capital requirements were regarded as insufficient and were supplemented by explicit dividend restrictions under the CC. The SEL does aim at protecting shareholders through disclosure of accounting information, but its accounting measurement standards have traditionally been subordinate to those of the CC because the accounting standards as laid out in the BAP had no legal status.

Consolidated financial statements

Ever since joint stock companies created subsidiaries consolidated financial statements have been the norm in the US. For Japanese accounting standard setters, consolidation accounting presented a challenge that took thirteen years to overcome. Already in March 1965 the MOF entrusted the BADC with task of investigating the establishment of a consolidated financial statement system. On May 19, 1967 the BADC issued its *Opinion on Consolidated Financial Statements*.[136] It was meant as a general guideline for or introduction to consolidated financial statements, and recommended preparation of the necessary environment for consolidated financial statements.

The challenge should be sought in protest from Japanese business organisations because consolidation would reduce their scope for income smoothing. *Regarding the Opinion on Consolidated Financial Statements, 1: Details on the Deliberation* of 1967 quotes a reaction from the business community to a previous draft as follows: “We recognise the necessity and inevitability of a consolidated financial statements system. However, it is difficult to approve of prompt implementation, we need time to nurture consolidation practice and set up an environment for consolidation.” Consolidation accounting applied from April 1978, but only under the SEL. It then took another twenty-five years or so for consolidated financial statements to be introduced under the CC, and replace unconsolidated financial statements’ primary position under the SEL.

4.1.5. Accounting concepts and approaches in the US and Japan

Income measurement

Both the US and Japan used the transactions approach to determining profits. That is to say, both countries adhere to the historical cost principle, practice accrual accounting, and summarise the income-related transactions for a period in an income statement. However, in 1985 the definitions of assets, liabilities and equity in SFAC No. 6 replaced those of APB4. Defining assets as probable future economic benefits rather than economic resources, liabilities as probable future sacrifices of economic benefits rather than economic obligations, and equity as residual interest in the assets of an entity after deduction of liabilities, the FASB adopted an “asset-liability approach to the measurement of stocks and flows that is prevalent in many subsequent standards” (Schroeder, Clark and Cathey, 2001, p. 141).

Especially during the 1990s the matching concept has increasingly

[136] 連結財務諸表に関する意見書

come to emphasise flows instead of stocks. In other words, assets and liabilities are accounted for with regard to the uncertainty of the cash flows they are expected to produce or consume. Current cost and net realisable value replace historical cost in the case of loan or capital asset impairment. Market price and fair value replace historical cost in the case of financial instruments.

Japan too abandoned the strict historical cost convention when she carried out the accounting big bang between 1998 and 2001. With the introduction of the Japanese Conceptual Framework in 2004 definitions of assets, liabilities, and equity became similar to those in SFAC No. 6.

Capital maintenance

As inflation has not been a problem in either the US or Japan, capital maintenance in relation to inflation accounting has not played a significant role over the period under discussion. Both countries adhere to the financial capital maintenance approach. Capital maintenance for the purpose of creditor protection has been discussed above.

Definitions of liabilities and equity and distribution of income concepts

Until the FASB issued *Accounting for Contributions Received and Contributions Made* (SFAS No. 116) in 1993, donated assets were recorded at their fair market value and an equity account named "donated capital" or "donated assets" recorded a similar amount (Schroeder, Clark and Cathey, 2001, p. 242). Presently, both countries adhere mainly to the proprietary concept of income distribution. For example, donated assets or contributions are considered revenue rather than capital (SFAS116, par. 8).[137] Interest payments, employee remunerations (except for directors' bonuses), and tax expenditures are considered expenses rather than income for distribution. According to Fujii (1997, p. 53) because shareholders bear the legal rights and obligations, the CC formally adopts the proprietary concept but in reality the entity concept applies.

Clean or dirty surplus, and comprehensive income

APB Opinion No. 9 adopted a modified all-inclusive concept of profits approach. "A number of subsequent pronouncements require irregular items to be highlighted so the reader of financial statements can better determine the long-run earning power of the enterprise" (Kieso and Weygandt, 1998, p. 155). Examples of items not disclosed in the traditional income statement are: foreign currency translation adjustments, unrealised holding gains and losses on available-for-sale securities. In order to disclose all changes in equity resulting from transactions and events other than those resulting from investments by and distributions to owners, SFAS No. 130 requires comprehensive income to be reported with the same prominence as other financial statements for fiscal years beginning after December 15, 1997 (Schroeder, Clark and Cathey, 2001, p. 117).

In Japan too, the income statements are prepared in accordance with the all-inclusive concept of profits. Income statements show operating profits, recurrent profits (profits resulting from operating and non-operating activities),

[137] Fisher, Iannaconi and Lechner (2001, p. 2908) classified donated assets as additional paid-in capital.

special (unusual) profits and losses, and net profits before and after taxes. Presently there is no requirement to report comprehensive income. Rather, the business community as represented by Keidanren opposes the disclosure of comprehensive income arguing that the information is readily available in the financial statements. However, as a result of the convergence project with the IASB it is possible that their position will have to change.

Full disclosure

The full disclosure principle "calls for financial reporting of any financial facts significant enough to influence the judgement of an informed reader" (Kieso and Weygandt, 1998, p. 1342). In the US the accounting profession has adopted the full disclosure principle. Materiality and cost-benefit considerations impose constraints on full disclosure. Voluntary disclosure is usually motivated by cost-benefit considerations only.

Formally, according to the Financial Statement Regulations [138] (accounting under the SEL) financial statements had to be prepared, and information had to be disclosed, in such a way that it would present a true picture of the company's financial situation and business performance (FSR Art. 5-1), and that it would not be misleading interested parties' judgement about the financial and business situation of the company concerned (FSR Art. 5-2). For consolidated financial statements the corresponding articles are C-FSR Art. 4-1 and 4-3.[139] Although this indicates a much more minimalist interpretation of disclosure than in the case of the US, strict adherence to these rules would already greatly benefit the quality of the information presented.

4.2. Comparing recognition and measurement

4.2.1. Recognition of revenue and expenses

In both countries revenue is usually recognised at the point of sale (Schroeder, Clark and Cathey, 2001, p. 72; Takeda, 2003, p. 219). Other possibilities for the timing of revenue recognition are when services are performed or when cash is received. Revenue for mining products and agricultural products is often recognised at production basis or crop basis respectively. For long-term projects there are the percentage-of-completion method and the completed-contract method. If the total costs can be reasonably estimated the first method is preferred in the US. In Japan companies were free to choose either. Since April 1998 the Corporation Tax Law requires the percentage-of-completion method (Sakurai, 2001, p. 1747).

Through the matching process costs are capitalised, charged to expenses, or written off as losses depending on whether they produce revenue or not in present or future periods. Of course the mechanisms are the same in Japan and the US.

4.2.2. Recognition of assets and liabilities

[138] 財務諸表等規則

[139] Consolidated Financial Statement Regulations (連結財務諸表規則)

US accounting standards criteria for recognising assets and liabilities in the balance sheet require first and foremost meeting the definition of assets as possible future economic benefits and liabilities as possible future sacrifice of economic benefits in SFAC No. 6. In order to maintain a sharp distinction between debt and equity accountants developed classification criteria. For example if a financial instrument has a maturity date and maturity value, in which case it would be classified as a liability (Schroeder, Clark and Cathey, 2001, p. 306-310). In 2003 the FASB issued *Accounting for Financial Instruments with Characteristics of Liabilities, Equity or Both* (FAS150), however, it has postponed amendment of the definition of liabilities in SFAC No. 6 because further deliberation is deemed necessary. FAS150 classifies financial instruments as liabilities when there is an obligation on the part of the issuer to redeem, repay, or settle.

In Japan, there was no explicit definition of assets and liabilities to aid in determining recognition criteria until the Japanese Conceptual Framework (JCF) in 2004. Presently the JCF defines assets as economic resources that are the result of past transactions or events, and that are under control of the reporting entity (JCF item 4). Liabilities are defined as obligations to transfer or give up economic resources under the reporting entity's control as a result of past transactions or events (JCF item 5) (Kawamura, 2005, p. 66).

4.2.3. Measurement of assets

Generally, valuation of assets shall be at historical cost price both in Japan and the US. The definition of assets in SFAC No. 6, par. 25 reads "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events". Because these future economic benefits are supposed to contribute to future net cash flows, valuation of assets has come to be regarded in terms of their influence on future cash flows in addition to past cash flows represented by the historical cost price.

In the US, historical cost price valuation for inventories is always subject to the lower-of-cost-or-market rule. In Japan, the lower-of-cost-or-market method is mandatory only when two conditions are met. First, if the market value has declined substantially, and second, if the decline in value is expected to be permanent. Otherwise the lower-of-cost-or-market method is optional. (until 2002 CC Art. 285-2, in 2003 amendment to the CC moved to CC Implementation Regulations, No. 28) The tax regulations consider a 50 percent decline "substantial" and allowed deduction of the loss from taxable income (Sakurai, 2001, p. 1751).

Marketable securities in the US were divided into current assets and fixed assets (investments). *Accounting for Certain Marketable Securities* (FAS12) issued in December 1975 required the marketable equity securities classified as current assets to be valued at the lower of their aggregate cost or aggregate market value. Losses were to be charged against income. "If losses had been previously recorded, a subsequent recovery of market value was to be reported as income to the extent of previously recorded losses" (Schroeder, Clark and Cathey, 2001, p. 212). *Accounting for Certain Investments in Debt and Equity Securities* (FAS115) became effective for fiscal periods starting after

December 15, 1993. FAS115 classified equity and debt securities into (1) trading securities, (2) securities available for sale, and (3) securities held to maturity. Trading securities are to be valued at fair value, and all unrealised holding gains and losses are to be included in earnings. Securities available for sale shall be value at fair value, but unrealised holding gains and losses shall be reported as a component of other comprehensive income. Held-to-maturity securities shall be reported at amortised cost.

When an investing company has significant influence over the financing and operating decisions of an investee company the investment shall be recorded using the equity method. Significant influence is thought to exist when the investor company holds between 20 and 50 percent of the investee company's stock.

In Japan, the Commercial Code (CC) required valuation of bonds (CC Art. 285-5) and stocks (CC Art. 285-6) at acquisition cost until the introduction of *Accounting Standards for Financial Instruments* (ASFI) valid from April 1, 2000. For years ending March 31, 2000 or before, the lower-of-cost-or-market rule applied in the same way as for the valuation of inventories. Because of the loose interpretation of the lower-of-cost-or-market rule, it happened that many companies did not disclose the huge amounts of unrealised holding losses that had been caused by the market decline in the wake of the burst of the bubble economy. Valuation losses were treated as non-operating expenses or extraordinary losses (Sakurai, 2001, p. 1753). Unrealised holding gains were not recognised or in any way disclosed, but served as hidden reserves increasing the scope for earnings management. Since 1983 the equity method has been required for unconsolidated subsidiaries and for companies of which the investor company holds between 20 and 50 percent of its common stock.

The new *Accounting Standards for Financial Instruments* in Japan were influenced by FAS115 and IAS39, and classifies securities as trading securities, held-to-maturity securities, stocks of subsidiary and associated companies, and other securities. Trading securities are bought and sold for profit making and are therefore to be recorded at fair value, and holding gains or losses are to be included into the calculation of net profit for the period. Held-to-maturity securities are to be reported at amortised cost. Stocks of subsidiaries or associated companies are to be valued at cost. Other securities are to be recorded at fair value, and holding gains or losses are to be measured using the *araikae*-method, and can be either recorded directly in the equity section of the balance sheet (after adjustment for the tax effect), or in case of holding losses may also be treated as a loss in calculating net income for the period. (ASFI No. 3-2)

Tangible fixed assets are valued at historical cost price both in the US and Japan. *Accounting for the Impairment of Long-Lived Assets to be Disposed Of* (FAS121) issued in 1995 requires companies "to review long-lived assets (including intangibles) for impairment whenever events or changes in circumstances indicate that the book value may not be recoverable."

4.2.4. Measurement of liabilities

In SFAC No. 6 liabilities are defined as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provided services to other entities in the future as a result of past transactions or events” (Schroeder, Clark and Cathey, 2001, p. 141). Payables and current maturities are recorded at face value. ABP Opinion No. 21 (*Interest on Receivables and Payables*) requires interest to be calculated where it is not stated, for long-term notes payable (Schroeder, Clark and Cathey, 2001, p. 220 and 321).

In Japan too liabilities are recorded at face value. Interest on notes receivable is not commonly charged or recorded.

4.3. Summary

Chapter 4 has presented a comparison of the accounting systems of the US and Japan with regard to characteristics, functions, conceptual approaches of these systems, and their recognition and measurement standards. The research question of part 2 of this dissertation is concerned with whether or not convergence of accounting standards between Japan and the US has been taking place over the years. In answer to this question chapter 4 has found that the internationalisation of business financial and capital markets has led the functions of accounting standards to become more similar. This is largely due to changes in Japan’s accounting environment, such as deregulation of the financial system, and the systemic shift toward a market economy. These changes forced regulators to reconsider how accounting standards could best serve the Japanese economy.

Characteristics and conceptual approaches have converged in a similar manner, especially after the accounting big bang, the establishment of the ASBJ, and most recently the ASBJ Conceptual Framework. Differences between the ASBJ Conceptual Framework and the FASB Conceptual Framework involve the qualitative characteristics of financial accounting information, and definitions of the elements of financial statements, and recognition and measurement. According to the FASB Framework accounting information should be decision-useful, relevant and reliable. The ASBJ Framework states that accounting information should be decision-useful, reliable, and produced based on internally consistent accounting standards. Tsumori (2005, p. 5-6) claims that the importance attached to internal consistency of accounting standards is the largest difference between the ASBJ Framework and overseas frameworks.[140] This is supposed to have originated in hard lessons learned through the accumulation of historical experience as a code law country plagued by internal inconsistencies of its accounting standards.[141]

In the FASB Framework definitions of financial statement elements as

[140] For some reason unknown to me the “ASBJ Financial Accounting Conceptual Framework” is in Japan usually abbreviated as *tougishiryou* or “discussion materials”.

[141] It appears that ASBJ is of the opinion that the importance of “internal consistency of rules and standards” in code law countries is not enough appreciated internationally.

well as decision-usefulness of information form the basis for measurement and recognition. The ASBJ Framework on the other hand, bases measurement and recognition of assets on the definitions of elements of financial statements, decision-usefulness of the information, and what it calls ‘internal consistency’ of accounting standards. Recognition of revenue and expenses depends on the definition of net profits as investment results free from risk (Kawamura, 2005, p. 70). Hitherto Japanese accounting standards religiously adhered to the realisation principle, and now they changed the terminology used in the FASB Framework from ‘realised’ or ‘realisable’ into ‘free from risk’.

Based on the above, one could say that very recently both accounting systems have come closer than ever before. However, the Japanese accounting system as exemplified by its new Conceptual Framework seeks to strike a balance between maintaining its own identity whilst fitting in internationally in order to provide a level playing field for Japanese companies that are participating in international markets. Chapter 5 will investigate the situation for the US and Japanese disclosure systems.

Chapter 5: The US and Japan's Financial Disclosure Systems

5.0. Comparison of disclosure standards between US-GAAP and JP-GAAP

Chapter 4 has shown that the characteristics and underlying concepts of the Japanese accounting system have grown more similar to those of the US accounting system. This change has most likely been caused by Japan's shift from state-led "political capitalism" characterised by a strictly regulated economy to "rational capitalism" in the form of a market economy in the late 1980s and throughout the 1990s.[142] Rationality implies that under rational capitalism, the role of publicly available information is much larger than under political capitalism. In this chapter the focus will be on the disclosure systems of both countries, particularly disclosure in consolidated financial statements.

In the US full disclosure meant that information had to be disclosed

[142] Here I borrow Weber's typology of capitalism as it is explained in Swedberg (1998), p. 46-49. Political capitalism has three modes: (a) predatory political profit-making, which could be used to finance wars, (b) continuous profit-making through the use of force or domination, for example monopolies, and (c) profit-making due to unusual dealings with political authorities, such as in the case of bribing or more specifically Japanese *amakudari*, the practise where companies give attractive jobs to retiring bureaucrats in order to benefit from their contacts inside the ministries.

when it was thought that it would influence investors' decisions. Japan, on the other hand had an accounting system based on the Commercial Code (CC). Because the CC was aimed at the protection of creditors and their interests over those of shareholders and other investors by calculating distributable end taxable income, disclosure of information that is useful to investors played a minor role. Disclosure in the Japanese accounting system was based on the Securities and Exchange Law (SEL). The SEL, through the accounting standards in the Financial Accounting Regulations (FSR) and the Consolidated Financial Statement Regulations (C-FSR), had the best interests of shareholders in mind. But its role was secondary to the CC in terms of accounting standards related to recognition and measurement. Article 15 of the C-FSR requires the disclosure of information that is not specified by the C-FSR but that is deemed necessary for the interest parties to make proper judgements about the company's financial situation and management under the heading of 'additional information'[143]. It is probably due to the unspecific nature of Art. 15 of the C-FSR, that very few companies ever disclosed 'additional information'.

This chapter compares the disclosure standards for annual financial statements under US-GAAP with the disclosure standards for annual consolidated financial statements in Japan between 1985 and 2003. Specifically, the focus for comparison is on the information disclosed in the notes and supporting schedules to the consolidated financial statements. Within the perspective of this dissertation, the comparison of US and Japanese accounting and disclosure standards for consolidated financial statements serves two purposes. The first is to illustrate that the information disclosed in consolidated financial statements produced under US-GAAP was superior in quality and quantity to that under JP-GAAP between 1985 and 2003. As such, this chapter does not presume to present an exhaustive comparison of the US and Japanese accounting and disclosure systems. Secondly, comparing Japanese consolidated financial accounting and disclosure standards with what in both the US and Japan were presumed to be the highest standards in the world creates a means for quantifying voluntary disclosure in Japan.

In order to present a more complete picture of the change in status of consolidated financial statements in Japan, reference will be made to the differences between disclosure standards for consolidated financial statements under the SEL, unconsolidated SEL and occasionally even CC disclosure standards. The US-GAAP table, the SEL-consolidated table, and the SEL-unconsolidated table in the appendix to Chapter 5 present an overview of the regulations that will be discussed in this chapter. The disclosure index that is presented at the end of this chapter is then used in chapter 6 in order to investigate relations between accounting disclosure, the cost of capital, and corporate governance structures.

Comparisons will be made of the financial statements required, disclosure of accounting policies, accounting changes, notes to the financial statements, and supplementary schedules. Since disclosure of information is only useful as long as it is reliable, true, and in accordance with accounting

[143] 追加情報

standards, this chapter also compares the audit systems of both countries. Remaining differences between US-GAAP and JP-GAAP will be discussed, and the disclosure score sheet that is used in chapter 6 will be explained, followed by a summary and conclusions on the level and nature of convergence between the accounting and disclosure systems of both countries.

Here the period of analysis is the same as the period of the empirical analysis in Part 3, which is from 1985 to 2003. Although consolidated financial statements have been required under the Japanese SEL since 1978, Japanese consolidated disclosure standards between 1978 and 1985 changed very little. The most important change was the equity method being made mandatory for the valuation of unconsolidated subsidiaries since 1983. Data collection for all the sample companies was more complete from 1985. Therefore I chose 1985 as the starting point for the empirical analysis of Part 3 as well as for measuring the extent of convergence between US-GAAP and JP-GAAP in Part 2.

Generally, financial disclosure according to US-GAAP has been considered to be of higher quality and more extensive than that under JP-GAAP. US-GAAP does not distinguish between consolidated and unconsolidated disclosure. JP-GAAP considered consolidated financial statements of secondary nature and disclosure standards were minimal until this situation was addressed between 1998 and 2001.

Appendix II, Table A presents an overview of JP-GAAP for consolidated financial statements, Table B lists the disclosure requirements under US-GAAP, and Table C shows JP-GAAP for unconsolidated financial statements. The requirements are discussed throughout this chapter, and the tables clearly show the years in which regulations apply or when there were no regulations present.

5.1. Financial statements required

Financial statements required under US-GAAP over the period from 1985 to 2003 include consolidated financial statements only, except in cases where a company does not have subsidiaries. According to SFAC No. 5 a full set of financial statements should include (1) a statement of financial position at the end of the period, (2) a statement of earnings for the period, (3) a statement of cash-flows, and (4) a statement of changes in stockholders' equity. Notes to each financial statement are an integral part of the set.

In 1985 US-GAAP in the form of APB Opinion No. 19 still required a statement of changes in financial position, which was replaced by a cash-flow statement in 1987 when the FASB issued FAS95 "Statement of Cash Flows". The introduction of comprehensive income with prominent status necessitated a statement of changes in stockholders equity. Hitherto, companies had only issued a statement of changes in stockholders equity when there were large changes, otherwise they issued a retained earnings statement or appended retained earnings information to the income statement.

Art. 1 of the Consolidated Financial Statement Regulations (C-FSR) in Japan required the presentation to the Ministry of Finance of a consolidated balance sheet, a consolidated income statement, and a consolidated surplus statement which could also be combined with the income statement (Art. 71).

The statements had to include an audit report by an independent auditor or accounting firm. As of fiscal year 2000 in addition a consolidated cash-flow statement was added, followed by supporting schedules for bonds and long-term borrowings.

Unconsolidated financial statements were to include a balance sheet, income statement, a statement regarding the distribution of profits or the disposition of losses, and supporting schedules (Art. 1 of the Financial Statement Regulations, FSR). There were fourteen supporting schedules in total with details on (1) marketable securities, (2) tangible fixed assets, (3) intangible fixed assets, (4) investments in marketable securities of associated companies, (5) capital contributions to associated companies, (6) loans to associated companies, (7) bonds, (8) long-term borrowings, (9) loans from associated companies, (10) capital stock, (11) capital surplus, (12) legal reserves and voluntary reserves, (13) depreciation expenses, and (14) provisions. All of the above were subject to an independent audit. Supplementary schedules for intangible fixed assets and depreciation expenses were abolished in 1993.

The Commercial Code required an unconsolidated balance sheet, unconsolidated income statement, unconsolidated business report and an unconsolidated proposal pertaining to the distribution of profits or the disposition of losses to be presented to the general shareholders meeting (CC Art. 281). Only companies with a capital stock over 500 million yen or liabilities over 20 billion yen had to present an audit report by an independent auditor to their shareholders.

5.2. Disclosure of accounting policies, accounting changes, disclosure changes, and the scope of consolidation

APB Opinion No. 22*,* “Disclosure of Accounting Policies*”* recommends disclosure of the accounting policies followed by the reporting entity and the methods used in applying these policies in a “Summary of Significant Accounting Policies” preceding the footnotes or as a first footnote. Disclosure is particularly important in case of (1) existing alternative accounting treatments, (2) principles and methods that are particular to the reporting entity’s industry, or (3) unusual or innovative applications of US-GAAP (Schroeder, Clark and Cathey, 2001, p. 520).

Examples of significant accounting policies include: consolidation method and basis of presentation, fiscal year, what constitutes cash and cash equivalents, cost flow method used for inventories, condition of plant assets, valuation method for plant assets and intangibles, depreciation methods used, pension and retiree benefit plans, income taxes, the use of estimates, reclassifications. More recent additions are: classification of investments, fair values of financial instruments, and derivative financial instruments.

C-FSR Art. 13 requires disclosure of items related to the consolidation, such as the scope of the consolidation, use of the equity method, differences in accounting periods with consolidated subsidiaries, accounting policies, cancellation of investment and capital accounts, unrealised intra-group profits, consolidated overseas subsidiaries, distribution of income, and inter-period tax

allocation upon consolidation. Disclosure of changes in accounting policies and disclosure methods are required by C-FSR Art. 14.

Art. 26 of the C-FSR Instructions, which are the predecessor to the C-FSR Guidelines, lists the following items for which the accounting policies should be disclosed: (1) valuation standards and measurement of assets, (2) fixed assets that are depreciated and the depreciation method used, (3) standards for reporting provisions, (4) the currency conversion standard used for overseas assets or liabilities, and (5) since 1994, the treatment of leases.

In the US a subsidiary is a company in which its parent company has a controlling interest, which is a voting interest of more than 50 percent. In the unconsolidated parent company financial statements investments in subsidiaries are accounted for using the equity method. In 1987 FAS94 “Consolidation of All Majority-Owned Subsidiaries” amended ARB 51 “Consolidated Financial Statements” issued in 1959. For fiscal years after December 1988, FAS94 “requires consolidation of all majority-owned subsidiaries even if it has ‘non-homogenous’ operations, a large minority interest or a foreign location” (FAS94, Summary).

The only exception presently allowed is when a parent company is precluded from exercising control. For example, in case the subsidiary is in legal reorganisation or in bankruptcy control rests with the courts or a court-appointed trustee irrespective of the fact that the parent company owns the majority of the voting stock. Differences in fiscal periods should not preclude consolidation of a subsidiary. If the difference is more than three months, adjustments will have to be made. For the time being, the FASB holds on to the concept of legal control even though it is not unthinkable that it will shift to the concept of effective control, as Japan has recently done.

Article 5 of the Consolidated Financial Statement Regulations (C-FSR) in Japan requires all subsidiary companies to be included in the consolidation, except when control (50 percent of voting stock) does not exist if the subsidiary is in reorganisation or bankruptcy, or when control is merely temporary, or when it is feared that consolidation of a company will be misleading interested parties’ judgement about (the financial and business situation of) the company group concerned. Until March 1994 companies could be excluded from consolidation if their assets, sales or profits were less than 10 percent of the group total (Kuroda, 2001, p. 1831-1832; Morita, 1999, p. 48). Since 1994 exclusion based on immateriality is no longer decided by mechanically applying a percentage, but based on whether or not exclusion would influence interested parties’ judgement.

Amendment to the “Consolidated Financial Statement Principles”[144] on November 24, 1998 changed the scope of consolidation from legal control to effective control. In other words, even if the parent company does not own the majority of voting stock but effectively controls the decision-making organ of a subsidiary company, that company will have to be included in the consolidation. This could be the case when (1) the parent company exercises control in the general shareholders meeting because there are other shareholders who do not

[144] 連結財務諸表原則

exercise their control, (2) the parent company exercises control in the general shareholders meeting through co-operation of shareholders such as the parent company's directors or related companies, (3) the majority of the board of directors of the subsidiary company is made up of present or former directors or employees of the parent company, or (4) contracts exist that give the parent company control over the subsidiary company's financial affairs or business policies.[145]

5.3. Notes and supporting schedules

Notes under US-GAAP do not typically concern only the balance sheet, the income statement or any other financial statement, but concern accounting or disclosure items or issues. Notes to the balance sheet, notes to the income statement and other notes is the classification customarily used under JP-GAAP because the FSR, C-FSR, and CC-R present the accounting standards in chapters that are each devoted to a separate financial accounting statement.

In the US, supporting schedules do not have a fixed format and are used in the notes to clarify or give a detailed breakdown of financial statement items. On the other hand, in Japan supporting schedules have fixed formats in accordance with the requirements of the FSR, C-FSR, and CC-R, the former two of which were decided by the JICPA, and the latter by the MOJ. Certainly, the formats of Japanese financial statements and supporting schedules make for superb comparability. Notes, however, can be disclosed in the form of footnotes or endnotes (C-FSR Art. 16), and for many under the CC-R their contents may also appear in the balance sheet as a separate item. This practice reduces comparability considerably.

5.3.1. Subsequent events, contingent liabilities, bills discounted and notes endorsed, and provisions related to contracts

FAS5 *Accounting for Contingencies* was issued in March 1975 and effective for fiscal years starting on or after July1, 1975. It requires the disclosure of loss contingencies such as: (1) the collectibility of receivables, (2) obligations related to product warranties and product defects, (3) risk of loss or damage of enterprise property by fire, explosion or other hazards, (4) threat of expropriation of assets, (5) pending or threatened litigation, (6) actual or possible claims and assessments, (7) guarantees of indebtedness of others, (8) obligations of commercial banks under 'standby letters of credit', (9) agreements to repurchase receivables (or the related property) that have been sold. (FAS5, par. 3) Estimated losses from contingencies may be accrued if the loss is probable and the amount can be reasonable estimated. (FAS5, par. 8) If no accrual is made, the contingency shall be disclosed if there is a reasonable possibility that the loss will occur. (FAS5, par.10)

In Japan, disclosure of contingent liabilities was required for unconsolidated financial statements under the SEL (FSR Art. 58), but for

[145] *連結財務諸表原則注解 (注解 5), Annotations to the Consolidated Financial Statement Principles (Annotation No. 5)*

consolidated financial statements under the SEL disclosure was required only since 1999 by C-FSR Art. 39-2. Separate disclosure in the notes to the consolidated financial statements of contingent liabilities in the form of bills discounted and notes endorsed was mandatory through C-FSR Art. 39-2 (changed into C-FSR Art. 39-3 in 1999). C-FSR Art. 44 required disclosure of provisions related to contracts with creditors that are included in the "other retained earnings" section of the balance sheet. Only since 2002 does accounting under the SEL require the disclosure of collateralised assets and liabilities for consolidated financial statements (C-FSR Art. 34-3). Disclosure of collateralised assets and borrowings was required for the unconsolidated financial statements (FSR Art. 43 for assets) and (FSR Art. 57 for borrowings).

5.3.2. Segmental disclosure

FAS14 "Financial Reporting for Segments of a Business Enterprise" was issued in December 1976, amended by FAS18 (November 1977), FAS24 (December 1978), FAS30 "Disclosure of Information about Major Customers" (August 1979), which were all superseded by FAS131 in 1997. Under FAS14 segment disclosures included sales, operating profit, and identifiable assets per business segment and per geographic segment. Other segment disclosures included depreciation and amortisation, and capital expenditures per business segment, as well as information on income from a company's main customers, and exports.

In Japan, segment information was considered proprietary information. Therefore companies that issued financial statements in accordance with US-GAAP sometimes would not disclose segment information before 1993. From April 1, 1990 sales and operating income per business and geographic segment were to be disclosed as un-audited supplemental information. Mandatory disclosure of externally audited segment information was introduced stepwise between 1993 and 1997 by C-FSR Art. 15-2. Disclosure of sales and operating profits or losses per business segment started per April 1, 1994. Business segment disclosure of assets, depreciation expenses and capital expenditures was made mandatory from April 1, 1995. At the same time geographic segment disclosure of sales, operating profits and assets was required. For the time being, companies could choose to disclose these items for the home country (Japan) and for all overseas countries lumped together. From April 1, 1997 geographic segmental disclosure was to be broken down into regions.

5.3.3. Leases

In the US, already in 1949 ARB No.38 required the disclosure of lease transactions in a footnote. APB Opinions No. 5 "Reporting Leases in Financial Statements of Lessees" (1964) and No. 7 "Accounting for Leases in Financial Statements of Lessors" (1966) were meant to tighten up the conditions under which a lessee would have to capitalise the leased asset. This marked a clear occasion where the issue of form-versus-substance moved into the direction of substance-over-form (Flegm, 1984, p. 91). The FASB issued FAS13 "Accounting for Leases" in November 1976, and FAS98 "Accounting for Leases" as an

amendment to FAS13 and other pronouncements in May 1988. FAS13 and FAS98 stipulate the criteria to decide whether the lease is a capital (finance) lease or an operating lease. In the first case the leased property shall be recorded as an asset in the balance sheet of the lessee, and in the second the lessor is the owner of the property and the lessee shall merely charge the rental fee to expense.

In Japan there were no accounting standards with regard to leases except for in the tax laws until 1995. Leasing in Japan set off later than in the US. As a means of off-balance sheet financing it was considered good for capital investment which was a major macro-economic goal. However, in the 1970s and 1980s the tax authorities realised that a large part of all capital assets in the country was leased property, and that the treasury lost out on corporation tax income. So the tax authorities set out to redress that problem. C-FSR15-2 since 1995 introduced lease accounting standards similar to the ones in the US. International and US accounting standards for leases are presently being scrutinised, so one might expect that the existent standards will need to be revised fairly soon.

5.3.4. Related party disclosures, claims to unconsolidated subsidiaries, obligations to unconsolidated subsidiaries

In March 1982 the FASB issued FAS57, which defines related party transactions as transactions between:

a. a parent company and its subsidiaries
b. subsidiaries of a common parent
c. an enterprise and trusts for the benefit of the of employees
d. an enterprise and its principal owners, management, or members of their immediate families
e. affiliates

Disclosure of material related party transactions in the financial statements shall include: 1. the nature of the relationship, 2. a description of the transactions, 3. the amounts of the transactions, 4. the amounts due from or to related parties, and the terms and manner of their settlement.

Japanese related party disclosures in consolidated financial statements between April 1, 1991 (fiscal 1992) and 1998 were based on the Disclosure Ordinance by the Ministry of Finance. However, these were un-audited. They could be viewed as a way to pacify US demands made during the Structural Impediment Talks. Since 1999 C-FSR Art. 15-4 requires related party transaction disclosure on par with FAS57. Related party disclosures in Japanese consolidated accounts that have been required since the beginning included claims toward unconsolidated subsidiaries (C-FSR Art. 34) and obligations to unconsolidated subsidiaries (C-FSR Art. 39).

Related party disclosures on an unconsolidated basis under the SEL included: 1. claims toward related companies (FSR Art.39), 2. obligations to related companies (FSR Art. 55), 3. sales to related companies (since 1987, FSR Art.74), 4. non-operating income from related companies (since 1987, FSR Art. 91), 5. non-operating expenses to related companies (since 1987, FSR Art. 94).

5.3.5. Marketable securities and investments

Since 1975, FAS12 required equity securities that were not accounted for under the equity method or consolidation to be valued at the lower-of-cost-or-market value at an aggregate portfolio level. These portfolios were to be recorded in the balance sheet as current or non-current equity investments. A change in the market value of the current equity investments portfolio would be reflected in the income statement. On the other hand, a change in the market value of the non-current equity investments portfolio would be reflected in the stockholder's equity section of the balance sheet. In any case, the difference between cost and current market value of investments in stock had to be disclosed. FAS12 did not deal with debt securities, but traditionally bonds were valued at the lower-of-cost-or-market value.

FAS115 superseded FAS12 in December 1993. Companies have to classify their equity and debt securities as trading securities, securities-available-for-sale, and securities-held-to-maturity. Trading securities are valued at fair value, in which case unrealised holding gains and losses are recognised in earnings. Securities-available-for-sale shall be reported at fair value, but unrealised holding gains or losses are no part of net income but are reported as a component of comprehensive income. Investments in held-to-maturity securities such as straight bonds are to be valued at amortised cost.

In Japan companies were free to choose cost or the lower-of-cost-or-market price for the valuation of all securities. Disclosure of market value in the notes to the consolidated financial statements was not required. In the supporting schedules to the unconsolidated financial statements marketable securities were broken down in stocks, bonds (public, national and regional), and other securities. For stocks disclosure requirements concerned description, price per share, number of shares, total cost price, and the value at which the stocks are recorded in the unconsolidated balance sheet. Disclosure regarding bonds included description, total face value, total cost price, and the value of the bonds in the unconsolidated balance sheet. Concerning other securities companies needed to list a description, the cost price and the value in the unconsolidated balance sheet. (FSR Form 1)

From the year 2000 C-FSR Art.15-6 requires valuation of and disclosure regarding securities that is similar to FAS115. Trading securities shall be valued at fair value, and unrealised holding gains or losses are to be reflected in the income statement. Held-to-maturity securities shall be valued at amortised cost. Shares in subsidiaries and associated companies are valued at cost in the unconsolidated financial statements. Subsidiaries are subject to consolidation but associated companies shall be valued according to the equity method in the consolidated financial statements. Other securities, such as holding a stake of up to 15 percent in a company but without yielding significant influence on that company's financial and business affairs, appear in the unconsolidated and consolidated balance sheets at fair value. Unrealised holding gains or losses are reflected in the equity section of the balance sheet, while taking the tax effect into account.

5.3.6. Derivatives and hedging

In 1990 the FASB issued FAS105 “Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk”. The information required by FAS105 includes the face, contract, or notional principal amount of financial instruments that create an off-balance sheet liability. Further disclosure requirements include the nature and terms of the instruments and their credit and market risk, cash requirements and related accounting policies, information regarding the maximum possible loss, collateral requirements, and the concentration of credit risk from an individual counterparty. FAS107 “Disclosures about Fair Value of Financial Instruments” was issued in 1991. It extended FAS105’s disclosure standards by requiring disclosure of the fair value of financial instruments including assets and liabilities both recognised and not recognised in the balance sheet.

Effective from December 1994, FAS119 required disclosure about derivative financial instruments, futures, forwards, swap and option contracts. Furthermore, it required distinction between financial instruments for trading purposes and for other purposes, and it required dis-aggregation of the information. Already in 1999, FAS133 superseded FAS119. It requires an entity to recognise all derivatives as assets or liabilities in the balance sheet at fair value. In case of a fair value hedge earnings shall reflect the extent to which the hedge is not effective. In case of a cash flow hedge, a gain or loss is reported in comprehensive income and subsequently reclassified in earnings when the forecasted transaction affects earnings. Foreign currency hedges of net investments in foreign operations are treated the same as the above two, depending on which case is appropriate. For derivatives that are not hedging instruments, gains or losses are recognised in earnings for the period.

In Japan there were no special rules for derivative financial instruments until the Accounting Standards for Financial Instruments[146] were pronounced in January of 1999, effective from fiscal 2000. On May 29, 1990 the BADC issued its “Opinion on Accounting Standards for Futures and Options Transactions”.[147] It advocated valuation of futures, options and marketable securities at fair value for companies that issued financial statements in accordance with the SEL. This information was supplementary in nature and was not audited (Sakurai, 2001, p. 1771). Only since 1998 does FSR Art.8-8 required disclosure in a note to the unconsolidated financial statements. Information to be disclosed was based on the BADC Opinion and included a description, the purpose, risk, the type of transaction, contract price, and the fair value of the asset or liability. C-FSR Art.15-7 requires disclosure in the notes to the consolidated financial statements in accordance with the Accounting Standards for Financial Instruments since April 1, 2000. Fair value is required except when a company uses deferral accounting for its hedging activities. From 2000, notes to unconsolidated financial statements need to include information on financial instruments only when the company does not prepare consolidated financial statements.

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[146] 金融商品会計基準

[147] 先物オプション取引等の会計基準に関する意見書等について

5.3.7. Retirement benefits and pensions

Prior to FAS87 “Employers’ Accounting for Pensions” (issued in December 1985), pension plans were not capitalised. The balance sheet only reported an asset or liability for the pension plan if the amount actually paid to the pension fund during the year was different from the amount reported as pension expense. Pension costs charged to income were to be disclosed (FAS36 “Disclosure of Pension Information: an amendment of APB Opinion No. 8”, issued in May 1980)). FAS87 adopted a capitalisation approach although it still retains certain features of non-capitalisation (Kieso and Weygandt, 1998, p. 1097).

Components to be included in the net cost recognised for a period by an employer sponsoring a defined benefit pension plan (FAS87 par.20):

a. service cost
b. interest cost
c. actual return on plan assets
d. amortisation of unrecognised prior service cost
e. gain or loss to the extent recognised
f. amortisation of the unrecognised net obligation or unrecognised net asset

Measurement of assets at fair value as of measurement date (FAS87 par.49)
Under a defined contribution plan, the contribution called for a period constitutes also the cost for that period (FAS87 par.64).

Disclosed in the financial statements are:
If the amount paid to pension funds is less than the amount recorded as pension expense, the difference will be recorded as a liability item in the balance sheet under the name of Accrued Pension Cost, or Due to Pension Fund. If the amount paid is more than the amount recorded as pension expense, the difference will appear in the balance sheet as an asset named Prepaid Pension Cost, Deferred Pension Expense or Prepaid Pension Expense. If the accumulated benefit obligation exceeds the fair value of the pension plan assets, the difference will appear in the B/S as a liability.

Disclosure in the notes to the financial statements includes: a description of the pension plan, the components of the pension cost, a schedule reconciling plan status with amounts in B/S, including: plan assets at fair value, PBO, ABO and VBO, amounts of unrecognised service costs and unrecognised gain or loss, additional or remaining liabilities, and the amount of deferred pension expenses or accrued pension cost in the B/S. Furthermore, the notes to the balance sheet will disclose the weighted average discount rate, the rate used to measure the PBO, and the weighted average expected long-term return on plan assets (Kieso and Weygandt, 1998, p. 1115-1116).

For many years, most Japanese corporations supported pension schemes based on defined benefits, to which most companies contributed the maximum amount charged to income allowed by the tax laws. The defined benefits per employee constituted of a lump sum payment equal to several times the annual salary, depending on the years of service. The maximum amount allowed to be charged to income was 40 percent of the total payments if all employees were to voluntarily leave at the end of the year. As a consequence retirement benefit liabilities came to be understated.

More and more companies are changing to defined contribution pension

schemes. These are also transferable in case one changes jobs. The Standards Related to Accounting for Retirement Benefits (SRARB)[148], effective from April 1, 2000, are largely comparable with the provisions of FAS87. Retirement benefit costs include: service costs, interest costs, return on plan assets, and the amortisation of unrecognised prior service costs and the net asset or liability (SRARB par.3-2). C-FSR Art. 15-8 requires retirement benefit disclosure in the consolidated financial statements.

5.3.8. Earnings per share and net worth per share

Since 1969, earnings per share disclosure requirements in the USA were based on APB15. Primary earnings per share and fully diluted earnings per share were to be disclosed on the face of the income statement (APB15 par.12 and 16). Criticism saying that the calculation methods were too complicated induced the FASB to issue FAS128 in February 1997, around the same time that the IASC issued IAS33.

C-FSR Art.65-2 and C-FSR Art. 44-2 require Japanese companies to disclose earnings per share and net worth per share respectively. Since 1995 diluted earnings per share have to be included (C-FSR Art. 65-2-2).

5.3.9. Deferred taxes

APB11 governed accounting for deferred income taxes from 1967. FAS37 amended APB11 in 1980. FAS96 superseded FAS37 from December 15, 1988. However, FAS109 reinstated FAS37 again in 1992. FAS109 par. 8b states that a deferred tax liability or asset is recognised for the estimated future tax effects attributable to temporary differences and carry-forwards. Deferred taxes shall be determined for each tax-paying component separately according to five steps laid out in paragraph 17. Included in income from continuing operations are valuation differences resulting from a change in judgement about the realisability of the valuation allowance (FAS109 par.26). Charged or credited to equity are:

a. adjustments of the opening balance of retained earnings due to accounting changes or correction of errors
b. gains and losses included in comprehensive income but excluded from net income (such as foreign currency translation adjustments under FAS52)
c. increases or decreases in contributed capital
d. expenses for stock options recognised differently for tax and for financial statement purposes (FAS109 par.36)

Presentation: The enterprise shall separate deferred tax liabilities and assets into a current and a non-current amount. (FAS109 par.41)

Disclosure:

a. the total of deferred tax liabilities measured in procedure (b) of paragraph 17
b. the total of deferred tax assets measured in procedures (c) and (d) of paragraph 17
c. the total valuation allowance recognised for deferred tax assets determined in procedure (e) of paragraph 17
d. the net change during the year of the valuation allowance

[148] 退職給付に係る会計基準

e. the approximate tax effect of each type of difference and carry-forward that gives rise to a significant portion of deferred tax liabilities and assets (before allocation of valuation allowances) (FAS109 par.43)

Disclosed in the financial statements or the notes thereto are:

a. current tax expense or benefit
b. deferred tax expense or benefit
c. investment in tax credits
d. government grants
e. benefits of operating loss carry-forwards
f. tax expense resulting from allocation to the contributed capital, or to reduce goodwill or other non-current intangible assets of an acquired entity
g. adjustments of a deferred tax liability or asset for enacted changes in tax laws, tax rates, or in the tax status of the reporting entity
h. adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgement about the realisability of the related deferred tax asset in future years (FAS109 par.45)

For most of the period under discussion, the Japanese Commercial Code did not allow rational inter-period income tax allocations. Under the SEL deferred taxes were permitted in the consolidated financial statements (C-FSR Art. 11) for the purpose of consolidating overseas subsidiaries.

Effective from April 1, 2000, tax effect accounting became mandatory for both consolidated and unconsolidated accounts. Although partly the result of a tendency towards international harmonisation of accounting standards, the tax effect accounting standards were a direct consequence of the bad loan problem faced by Japanese financial institutions. Having to write off huge bad loans, financial institutions needed ways to write off those bad loans and allocating the losses over several periods so as not to endanger their existence. The BADC issued the Tax Effect Accounting Standards (TEAS) on October 30, 1998. From April 1, 2000 the Tax Effect Accounting Standards were made effective and applicable to all companies. The TEAS consist of the following four parts:

1. *Recognition of temporary differences* explains that temporary differences may arise due to timing differences, revaluation of assets where the valuation difference is added to or deducted directly from the reserves, or upon consolidation (TEAS 2-1).
2. *Accounting treatment of deferred tax assets and deferred tax liabilities* prescribes that deferred tax assets or liabilities have to be recorded except in cases where the future payment or collection amount cannot be estimated, furthermore the amounts need to be reviewed every accounting period. The difference between the deferred tax assets and liabilities shall be compared at the beginning and the end of the accounting period. The increase or decrease shall be recorded as the adjustment amount (TEAS 2-2).
3. *Disclosure methods for deferred tax assets and deferred tax liabilities* states that a distinction shall be made between current deferred tax assets and investments and other assets, and current and fixed liabilities (TEAS 2-3-1).
4. *Items to be disclosed in the notes* include explanations for the occurrence of the deferred tax assets and or liabilities, item by item explanations for the

main causes in case of a large discrepancy between the legal tax rate and the effective tax rate (TEAS 2-4-2). TEAS 2-4-4 requires mention of a post-balance sheet date change in the tax rate, and the effects of the new tax rate.

Furthermore, there are eight explanatory notes. Number 2 explains that future deductions from earnings arise in case of capitalisation of bad loan reserves, pension reserves, and depreciation reserves, or in case of cancellation of unrealised profits on internal transactions with subsidiaries upon consolidation. Additions to income result from distribution over time of the allowances under the Special Taxation Measures Law, according to number 3. When the tax rate is amended the deferred tax assets and liabilities shall be recalculated based on the new tax rate (Number 6).

5.3.10. R&D expenditures

FAS2 “Accounting for Research and Development Costs” prescribes that all R&D costs are charged to expense when incurred. Total R&D costs shall be disclosed separately, usually in a footnote providing supplementary earnings information. FAS68 “Research and Development Agreements” centres on R&D activities carried out by one company on behalf of another company. Financial risk is borne by the company that is obliged to pay for the R&D activities irrespective of the outcome of the research, and thus results in a financial liability.

In Japan, testing, research and development costs were to be expensed as incurred, or capitalised as a deferred asset to be amortised within five years. Unconsolidated financial statements under the SEL disclosed technological research costs[149] in the income statement included in general administrative expenses or separately after selling expenses and general administrative expenses (FSR Art. 86). In consolidated financial statements the item sales and general administrative expenses usually appears as one item in the income statement, but had to be disaggregated into sales expenses and general administrative expenses in the notes (C-FSR Art. 5). Other items for separate disclosure included depreciation expenses and amounts added to allowances (C-FSR Guidelines No. 77). These other items were subject to a materiality threshold of 10 percent. In sum, there were no requirements to disclosure R&D expenses in the consolidated financial statements until 1999 when C-FSR Art. 55-2 was added after the BADC issued “Accounting Standards Concerning Research and Development Expenses”[150]. The new rules require R&D costs to be expensed as incurred. R&D costs for software developed for a company’s own use, or the master version of software developed for commercial purposes may be capitalised and depreciated using a rational method and over a reasonable period.

[149] 技術研究費

[150] 研究開発費等に係る会計基準

5.3.11. Long-term borrowings and bonds

In the US instruments with both liability and equity characteristics are accounted for by separating both components and treating the debt component as a liability, and the call option or warrant component as an equity instrument. APB No. 14 does not assign any portion of the issuance proceeds to the equity or conversion feature (Fisher *et al*., 2001, p. 2940). FAS47 “Disclosure of Long-term Obligations requires disclosure of the combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings. Furthermore, FAS47 required the disclosure of the amount of redemption requirements for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates. Other disclosure requirements include an explanation of the loan and the interest rate, the dates of interest and maturity payment, the total amount estimated to be repaid within the next five years, and the conditions in the loan contract. FAS150, issued in 2003, addressed the increasingly complicated issue of classification of the instruments combining debt and equity characteristics again. It suggests that SFAC6 may need to be revised as to the definition of liabilities. This is presently a task under consideration.

Extinguishment of debt leads to gains or losses which FAS4 “Reporting Gains and Losses from Extinguishment of Debt” classifies at extraordinary items in the income statement. Required disclosures include a description of the extinguishment transactions and the source of funds used for this purpose, the income tax effect in the period of extinguishment, and the per-share amount of the gain or loss net of the tax effect. In case of troubled debt restructuring FAS15 requires disclosure by debtors as follows. A description of the changes in the terms of the loan and the features of settlement, the aggregate gain and the income tax effect, the per-share amount of the gain net of the income tax effect, and the aggregate gain recognised on related transfer of assets (Schroeder, Clark and Cathey, 2001, p. 335).

Japanese financial accounting standards for consolidated financial statements did not require disclosure of details regarding bonds and long-term borrowings. Unconsolidated financial statements under the SEL were supposed to present supporting schedules for bonds and long-term borrowings. For bonds this information included a description of the bond, issue date, total issuing amount, amount repaid, outstanding balance, issue price, stated interest rate, mortgage, maturity date, and remarks such as foreign currency denomination (FSR Supporting Schedule Format No.7). Disclosure regarding long-term borrowings according to FSR Supporting Schedule Format No. 8 required the name of the creditor, the balance at the beginning of the period, increase for the period, decrease for the period, the balance at the end of the period, and remarks such as the type of collateral.

Since fiscal 2001 C-FSR requires supporting schedules providing information on bonds and borrowings for the consolidated financial statements as well. C-FSR Supporting Schedule Format No. 9 requires a description of the bond, the date of issue, the balance at the end of the previous period, the outstanding balance at the end of the period, stated interest rate, mortgage, maturity date, and remarks such as foreign currency denomination, details regarding the conversion option in case of convertible bonds and regarding the

issuing of new shares in the case of bonds with warranties attached. Important is also the requirement to disclose the amount of interest expected to be paid the next five years. Format No. 10 for the supporting schedule on borrowings etc. requires the disclosure of the balance at the end of the previous period, the balance at the end of the present period, the average interest rate, the maturity date (if applicable), and remarks separately for borrowings that are classified as short-term borrowings, the current portion of long-term borrowings, long-term borrowings (excluding the current portion), other interest-bearing liabilities.[151]

5.3.12. Impairment of long-lived assets and loans

Since December 1994 FAS114 "Accounting by Creditors for Impairment of a Loan – an amendment of FASB Statements No. 5 and 15" requires the difference between the recorded investment value (the principal plus accrued interest) of impaired unsecuritised debt and the net realisable value (the expected future cash-flows discounted at the loan's effective interest rate) to be recognised by creating a valuation allowance and making a corresponding charge to bad debt expense. In subsequent periods impairment is re-measured to reflect significant changes, which are in turn reflected in the valuation allowance account in the balance sheet and as an adjustment to bad debt expense. The carrying value of the loan may never be written up to exceed the original investment amount. Disclosures at each balance sheet date include the recorded investment in the impaired loans, the beginning, ending balance, increase and decrease in the valuation allowance account (FAS114), as well as the company's policy regarding the recognition of interest income from impaired loans (FAS118).

FAS121 "Accounting for the Impairment of Long-lived Assets and Assets to Be Disposed Of" after December 1995 states that impairment of long-lived assets occurs when the carrying amount is not recoverable. When events or changes in circumstances indicate that the book-value may not be recoverable by the sum of the future cash-flows expected to result from the use of the asset and its eventual disposal, companies are required to review tangible and intangible fixed assets for impairment. In this case the company shall decrease the value of the long-lived asset and recognise a loss for the difference between the carrying amount and the recoverable amount. FAS121 required disclosure of the impaired assets and the reasons for the impairment, the amount of the impairment loss and method of estimation, the location of the impairment loss in the income statement, and the business segments that are affected by the loss. FAS144 "Accounting for the Impairment or the Disposal of Long-Lived Assets" supersedes FAS121 from December 15, 2001. The new rules do not recognise impairment of goodwill (FAS142), and introduce the concept of probability-weighted cash-flow estimation.

The historical cost basis for valuation and measurement was so strongly entrenched in Japan that many companies were even reluctant to adopt the lower-of-cost-or-market rule. It is therefore not surprising that accounting for the

[151] For unconsolidated financial statements Format No. 7 (bonds) and No. 8 (long-term borrowings) have been renamed Format No. 10 (bonds) and No. 11 (borrowings etc.) and their disclosure requirements correspond to Format No. 9 and No. 10 for the consolidated financial statements.

impairment of assets and loans is a new addition to Japan's financial accounting standards. In August 2002 the BADC issued its "Opinion of the Establishment of Accounting Standards for the Impairment of Fixed Assets".[152] Early adoption of impairment accounting was possible from April 1, 2004, but adoption is mandatory from March 2006. Discussion of the Japanese standards therefore is outside the scope of this study.

5.3.13. Business combinations

APB Opinion No. 16 "Business Combinations" established rules to account for mergers and acquisitions using the pooling-of-interests and the purchase methods. All transactions involving the exchange of cash for voting stock had to be accounted for using the purchase method. In this case all the assets of the acquired company shall be recorded at their market value. The liabilities of the acquired company shall be deducted from this amount. Any excess between the acquired net assets and the cash amount paid is accounted for as goodwill. Goodwill was then amortised in a period not exceeding 40 years.

In the case of exchange of voting stock the pooling-of-interests method could be used if the combination met each of the twelve criteria concerning attributes of the combining companies, the manner of combining interests, and the absence of planned transactions that would make the exchange look like a merger but a purchase in substance (Schroeder, Clark and Cathey, 2001, p. 476; FAS141, Summary). When using the pooling-of-interests method to account for a business combination the parent company records its investment in the acquired company at the book value of its net assets. Goodwill does not arise. The subsidiary's retained earnings at the date of the exchange become part of consolidated retained earnings, and the subsidiary's earnings for the year of acquisition become part of consolidated income. FAS141 "Business Combinations", effective for business combinations starting after June 30, 2001, no longer allows the pooling of interest method. Furthermore, goodwill shall no longer be amortised. Instead it is subject to regular impairment tests and shall be carried at a value that does not exceed its fair value. A fixed intangible asset shall only be recognised apart from goodwill if it arises from contractual or legal rights, or if it can be separated from the acquired entity and sold, transferred or licensed (FAS141 Par. 39).

Disclosure requirements regarding business combinations include the name and a description of the acquired company, the method of acquisition and the details of the exchange (in case of the pooling-of-interests method; the kind and number of shares issued), the effect of including the acquired company's profits, in case of the purchase method; the amount of goodwill recorded and the amortisation method.

In Japan there was no comprehensive set of accounting standards for business combinations until the Accounting Standards Board of Japan issued its Accounting Standard No. 2 on October 31, 2003. Because hitherto the Commercial Code did not specify any rule for the valuation of a newly acquired

[152] 固定資産の減損に係る会計基準の設定に関する意見書. This was the BADC's final project before it passed on the baton to the ASBJ.

subsidiary except not to exceed market value, valuation was left to corporate management's discretion. The purchase method and the pooling-of-interest method have their Japanese equivalents in the "Contribution in Kind Theory" and the "Unified Character Theory"[153] respectively. Part of the logic behind these names may get lost in translation so an explanation is in order. The first theory considers the transfer of stock from the shareholders of the acquired company a capital contribution in kind, whereas the second theory regards the exchange of stock in the case of a merger as the way in which the equities of the two companies involved gain the character of a unified entity (Takeda, 2003, p. 882). Goodwill arising from the use of the purchase method was to be amortised in 5 years in the unconsolidated accounts and in 20 years in the consolidated accounts. Due to the fact that the Tax Laws considered revaluation of the acquired company's assets as taxable income, most Japanese companies used the pooling-of-interests method. However, some companies chose to revalue the acquired company's assets in order to offset the parent company's losses (Katagi, 2003, p. 160-161).

Surplus arising from merger was allowed to go into the capital reserve[154] of the acquiring company (CC Art. 288-2-5), the acquired company's legal profit reserve[155] and its other earned surplus (retained earnings)[156] were allowed to be transferred to the legal profit reserve and the other earned surplus account of the successor company. Disclosure of the contract of a business combination was to be in the business report, not in the notes to the financial statements and did not include the effect on profits of the acquiring company. The new Japanese accounting standards for business combinations will not be discussed here for lack of relevance to the period 1985 to 2003.

5.4. Auditing

US federal securities laws require all companies whose securities are publicly traded to file annual reports including a standard auditor's report with the SEC on form 10-K within 90 days of the closing of the books. Annual reports to shareholders include the same independent auditor's report. All these documents are publicly available from the SEC, the issuing companies and sometimes public libraries as well. Independent audits shall be carried out by a certified public accountant (CPA). In the case of public companies, independent audits are carried out by CPA firms that are a member of the SEC Practice Section of the AICPA, which requires additional quality control standards to be followed. Independence is defined as not having any type of financial interest in the company under audit (Fisher et al., 2001, p. 2980). The Enron and other scandals illustrated that independence had been compromised, after which the Sarbanes Oxley Act was introduced in 2002 to address this issue.

In Japan independent audits were a consequence of the introduction of

[153] 現物出資説 and 人格合一説 (also called 人格承継説 which translates as Continuity of Character Theory)
[154] 資本準備金
[155] 利益準備金
[156] その他の資本剰余金

the Securities and Exchange Law after WW II. The Commercial Code introduced first required independent audits in 1974 for companies with a capital stock of JPY100 million or more. In practice this meant mostly the companies that were already subject to independent audits by the SEL. Prior to 1974, the CC had required audits by a company's statutory auditor only. Since 1981 the CC requires independent audits of companies with a capital stock of more than JPY500 million or total liabilities of JPY20 billion (what the CC calls "large corporations"). Individual annual financial statements, consolidated annual financial statements, and individual semi-annual financial statements had to be independently audited under the SEL. Independent audits of consolidated semi-annual financial statements under the SEL are required since April 1, 2000 (Sakurai, 2001, p. 1786-1794).

This study is concerned with large corporations only. It is therefore very important to note that the Commercial Code does not recognise the need for financial statements of large corporations to be approved by their annual shareholders' meeting. If the statutory auditor and the audit corporation agree that the financial statements have been prepared in accordance with the law, the annual shareholders' meeting does not need to give their approval. They only need to give their approval regarding the proposal for the appropriation of retained earnings. Although the audits under the CC and the SEL are in effect one and the same audit, the financial statements under the SEL are not presented to the general shareholders' meeting but to the stock exchanges and the Securities Bureau of the Ministry of Finance (presently to the FSA).

5.5. Summary of differences between US-GAAP and JP-GAAP for consolidated financial statements

From the above it will have become clear that in 1985 the difference in disclosure requirements for annual consolidated financial statements between US-GAAP and JP-GAAP was substantial. The gap widened when the disclosure standards under US-GAAP increased whereas JP-GAAP remained fairly stagnant until the accounting big bang that took place in the wake of the financial big bang. Since then the gap has grown smaller to the extent that we can speak of convergence between the two systems.

Looking at the disclosure score sheet in Appendix II, Table D the grey areas indicate accounting and disclosure standards existing under US-GAAP without the existence of any disclosure requirements under JP-GAAP. The US-GAAP sheet indicates the main sources for the disclosure standards, and the C-FSR sheet indicates the disclosure requirements under JP-GAAP for consolidated financial statements in accordance with the Securities and Exchange Law. The FSR and CC sheets indicate the sources of disclosure requirements for unconsolidated financial statements under the Securities and Exchange Law and the Commercial Code respectively.

A mere glance at these sheets already indicates that US-GAAP added a cash-flow statement in 1987, a comprehensive income statement in 1998, disclosure of pension liabilities and assets in 1987, disclosure of derivative financial instruments in 1990, and the impairment of assets in 1994. On the other

hand, the white spaces on the C-FSR sheet clearly show that under JP-GAAP a cash-flow statement was not required until 2000, a comprehensive earnings statement is still not required, disclosure regarding bonds and borrowings started only in 2001, disclosure on leases and business and geographic segments from 1995 (although the latter in earnest from 1997), related party transactions, deferred taxes, R&D expenses, and contingent liabilities in 1999, marketable securities and derivative financial instruments in 2000, and retirement benefits and collateralised assets and liabilities in 2001. Each of these items has been discussed in detail in the corresponding paragraphs in this chapter.

Differences that remain include topics discussed above such as comprehensive earnings, and the valuation of long-term investments in equity stakes of less than 15 percent (at historical cost rather than fair value). More differences between US-GAAP and JP-GAAP remain and are the subject of periodic comparison by the large accounting firms. The present convergence project that is being carried out by the ASBJ and the IASB shall undoubtedly lead to further interesting developments.

5.6. Explanation of the disclosure score sheet

As mentioned above, the disclosure sheet in Appendix II, Table D shows grey fields that indicate existing disclosure and accounting standards under JP-GAAP for consolidated annual financial statements. The white fields indicate the margin for voluntary disclosure of financial statements such as a cash-flow statement, or of notes to the financial statements or supporting schedules. I filled in a printed sheet for each of the fifty-two companies in the sample, for which I read through the nineteen annual financial statements of every company. For every voluntary disclosure item I encountered I wrote down a Y indicating yes, and the number of the note in the financial statement. For every year I added up the Ys and the total number would indicate the disclosure score of the company for that particular year. Voluntary disclosure here does not mean qualitative information in the business report, but it means for example quantitative disclosure of contingent liabilities in the notes to the balance sheet of a trading company in the year 1990. Another example would be a note disclosing quantitative information regarding derivatives or retirement benefits in 1988. Each of these would be worth one point.

This immediately indicates two of the main weaknesses of the disclosure measure in this study. Firstly, there is the problem of bias and inconsistency in evaluating and transcribing the disclosure items.[157] Secondly, there is the problem of weighting the items in the disclosure score. All disclosure measures are subject to bias and inconsistency to some extent. However, as will be discussed in Chapter 6, my outcomes for the relation between the cost of equity and disclosure between 1996 and 2000 are similar in direction if not in extent to

[157] I assume that every teacher who has had to grade exams for five hundred or more students at a time knows this problem.

the outcomes in the study by Suda, Shutou and Ohta (2004a and 2004b). Therefore, I assume that the possible bias and inconsistencies in my disclosure measure are comparable the ones in the disclosure measure produced by the SAAJ.

5.7. Conclusions of Part 2

In Part 1 concluded that the internationalisation of business has had a profound influence on the development of Japan's financial accounting system. International political factors between 1868 and 1980 provided a rationale to adopt a macro-economic stance toward accounting standard setting. Because Japan had an interest in becoming a developed country as quickly as possible it developed some kind of state-led "political capitalism". While the Japanese business community (such as *Keidanren*) strived to maintain the status quo internationalisation continued. This had the consequence that Japan's financial accounting system did not change much between 1980 and 1996, but international business, financial and capital markets changed greatly. When Japan's financial system seemed on the verge of collapse the Japanese government took action and carried out an overhaul of the financial system starting in 1996 and the financial accounting system starting in 1998. The big bang has brought about a financial accounting system that has more characteristics of a micro-economic orientation toward accounting development. Such a shift is a prerequisite for convergence of JP-GAAP toward US-GAAP.

Part 2 answers the questions whether internationalisation of business, financial and capital markets has brought about convergence of financial accounting and disclosure standards between US-GAAP and JP-GAAP, and how convergence has come about as follows. Chapter 4 concluded that due to internationalisation of business, financial and capital markets, the role of public disclosure of financial information to shareholders and potential investors has gained importance over creditor protection. The introduction of fair value has brought Japan's measurement and recognition standards closer to US-GAAP. As the role of public disclosure has increased in importance, Japan's disclosure standards for consolidated annual financial statements too have shifted toward US-GAAP. Convergence in this sense means a categorical shift from lower accounting and disclosure standards to higher standards. A convergence project between the IASB and the ASBJ is currently under consideration. The outcome of this project is going to be very interesting.

As for the matter of the extent of convergence, the disclosure sheet, which is the basis for the disclosure scores in Chapter 6, shows that after the year 2000 there has been considerably less room for audited voluntary disclosure in the financial statements, the notes and the supporting schedules. Therefore the maximum possible voluntary disclosure scores after the year 2000 are low. However, the FASB and the ASBJ are very actively working on improving accounting and disclosure standards. It is possible that the FASB, the IASB and the ASBJ will work more closely together in the future.

Chapter 6: Empirical Study

6.0. Introduction

Part 1 of this dissertation explored the influence of internationalisation on accounting development in Japan. International political events played a significant role in firmly establishing the macro-economic approach to accounting development and regulation between 1868 and 1980. Internationalisation of capital and financial markets took place at an unprecedented rate in the 1980s and 1990s but in that period internal political clout of businesses prohibited the accounting system from responding to these changes until in 1996 the financial big bang was announced and the accounting big bang followed. From 1996 onward the accounting system was allowed to become more responsive to the market and to take on a micro-economic approach to accounting regulation. Part 2 of this study found that convergence between Japanese and US accounting and disclosure standards has taken place in the sense that the Japanese standards moved towards the US standards, particularly since the year 1998.

Part 3, or Chapter 6 is concerned with quantifiable economic rationales for voluntary disclosure. In the previous chapter we developed a disclosure index that will be used here as a variable to quantify consolidated voluntary financial disclosure in Japan between 1985 and 2003, and test if there is a negative correlation between disclosure and the cost of capital. Factors related to the degree of internationalisation of financing and corporate governance that may be influencing the cost of capital or the propensity for voluntary disclosure will also be investigated.

Section 6.1. provides an overview of studies into the relation between disclosure and the cost of capital and other factors that possibly influence disclosure policies. The research questions are stated in section 6.2., followed

by the formulation of the hypotheses in section 6.3. In section 6.4., I discuss sample and period selection, and description of the models, variables and summary statistics follows in section 6.5. Section 6.6. presents the empirical results, and section 6.7. summarises the chapter and presents the conclusions for Chapter 6.

6.1. Related studies

In recent years studies into the relation between the disclosure of accounting and other information and the cost of debt and/or equity capital have enjoyed increased popularity. Examples are Botosan (1997), Botosan & Plumlee (2000) for the relation between disclosure and the cost of equity capital, or Sengupta (1998) for the relation with the cost of debt. In Japan, Suda, Shutou and Ohta (2004a and 2004b) performed tests of both associations, inspired by and modelled on Botosan and Sengupta's studies.

Botosan (1997) and Botosan & Plumlee (2000) sketch a theoretical framework primarily based on Amihud and Mendelson (1986), Diamond and Verrecchia (1991), Dechow *et al*. (1996), and Healy and Palepu (1993 and 1999) as follows. On the one hand cost of capital is reduced by increased stock market liquidity (proxied by the bid-ask spread) due to increased disclosure. On the other hand greater disclosure reduces estimation risk and thereby investors' required rates of return. Sengupta (1998, p. 459-460) suggests that firms are charged lower risk premiums as a result of a perceived "lower likelihood of withholding value-relevant unfavourable information." Suda, Shutou and Ohta (2004a and 2004b) follow the above examples fairly closely, but carry out the exercises for the case of Japan.

Botosan (1997) documents an association between her self-constructed measure of disclosure and a cost of equity capital estimate based on the clean surplus concept and the "EBO valuation formula" for firms with low analyst following (which also happen to be considerably smaller companies with a lower beta) after controlling for beta and firm size. Botosan and Plumlee (2000) find the cost of equity capital decreasing with regard to disclosure in annual reports, but not for more timely disclosures such as the quarterly report. Their analysis covers the period between 1986 and 1996. This time they use the disclosure measure from the Association for Investment Management and Research (AIMR) reports. Sengupta (1998) uses the same disclosure measure to produce results indicating that firms with higher quality disclosure enjoyed better bond ratings, and a lower cost of debt.

Suda, Shutou and Ohta (2004a, p 38; 2004b, p. 66) proxy for disclosure level using the Securities Analysts Association of Japan (SAAJ) Reports. Their analyses for both the association between disclosure and the cost of equity (Chapter 1), as well as between disclosure and the cost of debt (Chapter 2) cover the period from 1995 to 2000. In both cases they find a significant negative association, indicating that it pays off to make use of what they call the "disclosure opportunity".

In Chapter 3 of that same book, Suda, Otomasa and Matsumoto (2004a)

test associations of voluntary disclosure of consolidated interim reports of September 1998 with trading volume, with beta as an indicator of risk, and with errors in analyst forecasts of recurrent profits.[158] They conclude that companies that voluntary issue consolidated interim statements enjoyed a higher liquidity of their stocks, and a lower cost of equity capital, and that the level of information asymmetry (proxied by the level of accuracy of analyst forecasts) was lower.

Then in Chapter 4, Suda, Otomasa and Matsumoto (2004b) embark on a quest to find if the companies that voluntarily issued the interim financial statements in September 1998 have any relevant common financial characteristics. Furthermore, they try to explain what the strategic motives for this voluntary disclosure are. They test the hypothesis that corporate managers of these firms intend to signal good news (signalling hypothesis). In addition they test the agency cost hypothesis (the larger the agency costs, the more important the role of information is perceived to be). Thirdly, they test the stock compensation hypothesis (companies that have introduced the stock option system are expected to voluntarily disclose good news). A fourth test concerns the corporate governance hypothesis (companies with more verbal shareholders are supposed to engage in better quality and more timely disclosure). And finally, they test what they call the direct financing hypothesis (companies that are more dependent on direct financing will try to reduce their cost of raising capital or funds by being more forthcoming with information).

Good news is supposed to be signalled through the rate of return on equity (roe). Suda, Otomasa and Matsumoto (2004b) proxy for agency costs using the book-to-price ratio, and for growth using growth in sales, based on a study by Kallapur and Trombley (1999). A dummy variable indicates whether or not a company chose to implement a stock option system by September 1998. Foreign investors are thought to be more demanding in terms of timely disclosure and appropriate corporate governance. Suda, Otomasa, and Matsumoto (2004b) use the percentage of shares held by foreign investors as a variable to test the corporate governance hypothesis. The direct financing hypothesis is tested using the ratio of bonds issues in 1998 and 1999 to total assets, and the ratio of new share issues in 1998 and 1999 to total assets. Suda, Otomasa and Matsumoto (2004b, p. 103) claim to have found that all five of their hypotheses have explanatory power, but the strongest are the corporate governance, direct financing, and the stock compensation hypotheses.

Suda (2004), tests the signalling, agency, corporate governance and direct financing hypotheses. He differentiates companies that voluntarily issue consolidated interim financial statements, companies that use tax effect accounting, companies that do both, and companies that do neither. Consolidated financial interim financial statements were required from April 1, 2000. The standards for tax effect accounting were set in December 1998, but applied from March 2000. Suda (2004, p. 119) finds that the corporate governance and direct financing hypotheses hold the strongest, but that there is some evidence to support the signalling hypothesis.

[158] Consolidated interim financial statements were required from April 1, 2000.

6.2. Research Questions

In an attempt to understand what motivates corporate managers to disclose more financial information than the legal minimum required, this study asks the following research questions:

1) Have companies that issued their consolidated financial statements in accordance with higher disclosure standards enjoyed a lower cost of capital?
2) Is there a relation between disclosure levels and corporate governance factors?

Findings by the prior studies discussed in section 6.1. indicate that such may be the case. There may be relations between the cost of equity capital and disclosure proxies and between the cost of debt and disclosure proxies. This study investigates correlations between the weighted average cost of capital and a voluntary disclosure proxy in Japan.

This study analyses the case of Japan because she offers us an opportunity to compare companies issuing consolidated financial statements in accordance with US-GAAP with companies following JP-GAAP since 1978. It is therefore possible to analyse the associations between disclosure and the cost of capital and between disclosure and company characteristics such as capital and ownership structure over a longer time-span. As markets change (see Part 1) and convergence progresses (see Part 2) the above associations can be expected to change as well.

6.3. Hypothesis formulation

6.3.1. Theoretical Framework

Presently there is not a very well-developed theoretical framework in which to place research into the motivations for voluntary disclosure, or more specifically the relation between voluntary disclosure of financial information and the cost of capital.[159] It is certainly within the realm of transaction cost economics because of the information asymmetry between corporate managers and users of financial statements and other corporate disclosure involved. Full financial disclosure could solve the adverse selection problem that stems from information asymmetry, but managers may fear that it would result in a loss of competitive advantage for their company.

Without any doubt agency theory applies because of the moral hazard that is inherent in the relationship between corporate managers and outside investors or creditors. This problem cannot even in theory be solved. It can only be mitigated by expensive contracts and monitoring mechanisms. Managers may choose not to disclose bad news for what they perceive as the benefit of the company as well as for private reasons. Or they may manipulate earnings or other numbers upwards or downwards if they think it serves the company or themselves. Disclosing overly optimistic forecasts may result in very costly

[159] Verrecchia also states that there is no comprehensive theory of disclosure in Verrecchia (2001), p. 98.

litigation suits.[160] Based on the above, voluntary disclosure decisions should therefore be viewed as the outcome of professional and private analyses weighing costs and benefits and risk and return by corporate managers.

The optimal allocation of savings to investment opportunities is a challenge for any economy because of information and incentive problems (Healy and Palepu, 2001, p. 407). Accounting and disclosure regulations aim to mitigate information problems. Contracts and corporate governance structures are used to provide solutions to incentive problems (Healy and Palepu, 2001, p. 409-410). Voluntary disclosure of financial information therefore addresses the first problem, and transparency of corporate governance structures helps solve the second.

What is the mechanism through which increased disclosure is negatively associated with cost of capital? Information asymmetry between companies and investors or creditors causes uncertainty with respect to companies' financial situation, corporate performance and business prospects. In turn uncertainty about the level of risk regarding an investment's future returns invites higher risk premiums. Uncertainty affects a stock's liquidity because stock market players (as opposed to investors for the long term) are more likely to invest in companies which they perceive to be easily divestible in case they need their cash for other purposes. Empirical evidence for this mechanism is found by Welker (1995, p. 810 and 822) in a negative association between a disclosure proxy and the bid-ask spread, and by Amihud and Mendelson (1986, p. 246) who document that liquidity-increasing financial policies reduce the opportunity cost of capital and increase the value of the firm.

Although not statistically significant, the findings in Welker (1995, p. 804) seem to indicate that the coefficients of the negative association between disclosure and liquidity are larger for firms with higher levels of shares held by institutional investors. These firms also experience larger bid-ask spreads. Welker (1995, p. 823) equates larger institutional shareholdings with higher levels of informed trade. The importance of Welker's study is that it points out correlations between disclosure and liquidity as well as between disclosure and ownership structure. As mentioned above, liquidity is associated with perceived risk and influences the cost of capital. Brailsford, Oliver and Pua (2002, p. 3, 6 and 23) found ownership structure to be associated with capital structure in the sense that at low levels of managerial ownership a large presence of external block-holders leads to higher debt ratios. At high levels of managerial ownership, managers will have incentives to lower non-diversifiable employment risk by reducing debt to sub-optimal levels in order to ensure the continued viability of the firm. It is possible that the results of this Australian study would not have been obtained in the Japanese case. Japanese managers were very powerful even in the absence of managerial ownership. Employees of large corporations enjoyed the benefits of lifetime employment. Nevertheless, institutional block ownership and high debt ratios are characteristics of many Japanese companies.

According to Dhaliwal (1990, p. 80 and 84), highly leveraged firms

[160] Until recently that was not very likely in Japan because lawsuits by shareholders were being discouraged by prohibitive costs and were thus rare.

have a distinct preference for accounting standards that allow flexibility to reduce volatility of reported earnings or net tangible assets in order to circumvent restrictive debt covenants. With regard to disclosure, Zarzeski (1996, p. 24) found support for the hypothesis that "Companies with lower debt ratios are expected to have higher levels of investor-oriented disclosures." The idea behind this hypothesis is that companies with higher debt ratios are likely to share more private information with their creditors (Zarzeski, 1996, p. 31). Solving information asymmetry problems through private information sharing is thus associated with dependence on debt or more particularly indirect financing. On the other hand, in the case of direct financing there is more reliance on and thus a stronger demand for public information. Similar findings are presented by Ball, Kothari and Robin (2000).

Similarly, in the case of higher levels of relationship investing where larger percentages of a company's shares are held by banks and companies within the same *keiretsu*, private information sharing is expected to reduce the need for public information disclosure. On the other hand, when larger percentages of shares are held by foreign and individual investors the demand for and thus the level of public information disclosure is expected to be higher.

6.3.2. Formulation of the hypotheses

As we have seen in section 6.1., there is some empirical support for negative associations between disclosure and the cost of equity, and between disclosure and the cost of debt. If that is the case, one expects the same hypothesis to hold for the relation between voluntary disclosure and the weighted average cost of capital (WACC) as well. As this chapter's main aim is to find a quantifiable economic rationale for corporate managers' decisions to voluntarily disclose financial information, it will first investigate the WACC which is the cost of capital that matters to corporate managers in the process of economic value creation.

Discounting the expected cash flows to the firm at the firm's weighted average cost of capital estimates the value of the firm. Firm value is thus a function of cash flows and the WACC. Both of which are usually influenced by the degree of leverage (Damodoran, 2002, p. 404). Tax deductibility of interest payments is the reason why leverage influences a firm's cash flow. Higher risk of costly financial distress associated with a high degree of leverage raises the required rate of return of equity as well as the cost of debt, and thus at a certain point offsets the tax advantage of leverage and decreases firm value (Brealy and Myers, 1996, p. 213).

As debt and equity represent two different corporate governance systems, the first corporate governance choice a corporation makes is its degree of leverage. According to Williamson (1996, p. 180, 184-185), debt is a governance structure that works through arms length rules such as the obligation to make regular interest payments, meet liquidity requirements, in some cases the demand for compensating balances, and possible liquidation in the event of default. Equity represents a governance structure that on the one hand is more forgiving because shareholders are residual claimants, and equity lasts the life-time of the firm. However, through the decision-reviewing and

monitoring functions of the board of directors, the equity governance structure is much more intrusive.

The debt-equity mix is both the result of financing and corporate governance decisions. As we have seen in Chapter 2, since World War II, Japanese companies have become more highly levered. Companies that are more actively raising capital at international markets (listed on foreign stock exchanges) are expected to depend less on borrowing and more on equity capital. These companies are likely to attract a higher percentage of foreign shareholders and to be more actively engaged in voluntary disclosure.

Resource dependence is probably what motivates the managers of these companies to seek funds at international capital markets. Larger corporations need more funding because they invest more in productive capacity. Other motives may be related to the public image that a company wants to be associated with, such as an image of international success, or of being at par with international standards. In the international arena it also matters to facilitate comparison with competitors. Larger companies that occupy a leading position in their industry may be less concerned about proprietary costs. It is also possible that in Japan, where banks are creditors to and shareholders in the same companies, the move toward international capital markets signifies emancipation from the main bank system and relationship investing.

In sum, the research hypotheses to be tested are:

1. ceteris paribus, there is a negative association between the cost of capital and the disclosure proxy (motivation for voluntary disclosure)
2. there is a positive association between the disclosure proxy and foreign shareholder percentage, and between disclosure and overseas stock-market listing (international standard are higher and foreign shareholders more demanding)
3. there is a negative association between disclosure and the percentage of shares held by the 10 largest shareholders, and between disclosure and the percentage of shares held by individual shareholders (proxy for interlocked shareholding where demand for disclosure is lower due to private information sharing, and individual shareholders have less clout)

6.4. Period and sample selection

6.4.1. Period of analysis

Although consolidated financial statements under the SEL have been required since 1978, the analysis starts with 1985 and ends in 2003. For the companies issuing their financial statements in accordance with US-GAAP data is available for the whole period from 1978 to 2003. This is not always the case with some JP-GAAP companies, simply because at that time they may not have been listed at the First Section of the Tokyo Stock Exchange yet. For most companies in the sample data is available since 1984, which is also the time that Japan's financial markets had largely been deregulated. Usually accounting years in Japan start on April 1 of year A and end on March 31 of year B. So data that I

labelled for the year 1985 are for the accounting period ending on March 31, 1985. A few companies have different accounting periods or have changed their accounting periods at some time between 1985 and 2003. Because my sample is small as it is, I could not permit myself the luxury of excluding these companies from the sample. The fact that the analysis covers nineteen years will make up for these possible differences.

6.4.2. Sample selection

There are fifty-two companies in the sample. It includes companies from nine different industries, of which the largest and the second largest are electronics and general trading respectively. Within the sample there are two sub-groups. Twenty-six companies in the US-GAAP group and twenty-six companies in the JP-GAAP group. Both groups have been constructed matching for industry, and to the extent possible for size. However, most of the companies in the US-GAAP group are the largest in their industry. In several cases I have had to compromise comparability in size to find matching JP-GAAP companies for which data were available over the whole period. So I chose matching companies that were the remaining largest in the industry. For a list of all the sample companies and how they are matched, please refer to Appendix III, Table A.

6.5. Model and variable description

6.5.1. Model 1

Firstly, pooled cross-sectional regressions following Model (1) test the hypothesis that there is a negative association between the WACC and disclosure.

Model (1) $wacc = \beta_0 + \beta_1 disc + \beta_2\, a\text{-}beta + \beta_3\, ln\ assets + \beta_4 lev + \beta_5\, btm$

The WACC is estimated as the weighted average of the debt capital after taxes and the cost of equity capital using the following formula:

$$WACC = d * k_d * (1 - \tau_c) + (1 - d) * k_e$$

where d is the ratio of debt to total capital, k_d is the cost of debt before taxes, τ_c is the marginal tax rate, and k_e is the cost of equity. Although the weights should be based on market-values for making investment decisions, this study uses book-values.

I have estimated the cost of equity using the Capital Asset Pricing Model (CAPM):

$$r = rf + \beta(rm - rf)$$

rf is the risk-free rate of return, rm is the market rate of return, and β is the market beta. $(rm - rf)$ is also known as the risk premium.[161] I chose the CAPM cost of equity because estimations based on the dividend discount model, average realised rate of return, and free cash flow to equity imputations result in a negative cost of equity for various sample companies in many observations. This is due to the fact that several of the sample companies produced severe losses.[162]

Market beta estimations are based on the "Rates of Return on Investment 2003" CD-Rom issued by the Japan Institute for Securities and Economic Research.[163] Monthly rates of return regressed over a period of sixty months produce a beta thought to be valid at January 1 of the next year. Because for several companies betas turned out to be negative in a number of years, I have used adjusted betas. Adjusted betas[164] are estimated as follows: *a-beta* = 0.35 + (*beta* x 0.65).

An approximation of the cost of debt is taken from the Nikkei Electronic Economic Data System (NEEDS) database (consolidated financial statements) and is the ratio of interest expenses to interest bearing liabilities.[165] The tax rate used in the estimation is the marginal tax rate as provided by the MOF website.

Table 3 presents an overview of the independent variables which will be discussed below.

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[161] Japan Institute for Securities and Economic Research (2003) "The Rates of Return on Investment 2003" CD-rom provided market rate of return, which I averaged from 1953 to 1980, and reduced the outcome by the average 10-year government bond interest rate over 1980 in order to arrive at a risk premium for 1980. For the 1981 risk premium I averaged the rate of return over the 1954-1981 period, and reduced the outcome with the average 10-year government bond interest rate in 1981, etc., etc. I used the average for the period 1954-2003, which was 4.4 percent, as the fixed risk premium.

[162] Suda, Shutou and Ohta (2004a) use a cost of equity estimation based on the residual income valuation model inspired by Botosan (1997), using analyst forecasts of recurrent profits in the *kaisha shikihou (Japan Company Handbook)*. But in several periods a number of my sample companies even had negative recurrent profits.

[163] The Japanese name is 株式投資収益率 *2003 年* by 財団法人日本証券経済研究所.

[164] Damodaran (2002), p. 186, mentions similar methods being used by Bloomberg and other services providing beta estimates. Damodaran calls this practice arbitrary and not particularly useful. However, negative betas push the CAPM cost of equity downwards and sometimes even into the negative, which distorts the view presented by estimations of average cost of equity capital, and these in turn distort the weighted average cost of capital estimates.

[165] 有利子負債率(*Yuurishifusai rishiritsu*), usually to be found on line number 719 in the NEEDS database for consolidated financial statements. In five observations (out of the 988) this number was missing so for these I used the number in the NEEDS database for unconsolidated financial statements, or if that was also missing I took the average of this number for the year before and the year after the missing observation. Bond ratings for all of the companies over the whole period from 1985 to 2003 were very hard to come by. Therefore I chose this proxy based on the assumption that the book value of debt is close to its market value.

Table 3: Independent variables of Model (1)

abbreviation	name
disc	*Disclosure score*
d-disc	*Disclosure dummy variable = 1 for US-GAAP company* *= 0 for JP-GAAP company*
a-beta	*Adjusted company beta*
Ln assets	*Company size measured as the natural log of its total assets*
lev	*Leverage: debt to total capital ratio in bookvalues*
btm	*Book-to-market ratio of equity*

Voluntary disclosure level: disc and d-disc

Disclosure score is indicated by a company's score in the voluntary disclosure index that has been developed in Chapter 5. The score is based on the information in the notes and supporting schedules to the consolidated financial statements. Performing the regression replacing the disclosure score with disclosure dummy variable serves to compare the US-GAAP and JP-GAAP group-specific results with the total sample results.

Market risk: a-beta

Adjusted beta controls for market risk because the higher the market risk the higher the returns required by investors and creditors (i.e. cost of equity and debt capital).

Company size: ln assets

Company size is a variable that is generally found to have a negative association with cost of capital and a positive association with disclosure. Examples of the former are Ou and Penman (1989) and Fama and French (1992), examples of the second are Cooke (1991) and Botosan (1997). Following Suda, Shutou and Ohta (2004a and 2004b), in this study the proxy for size is the natural logarithm of the book-value of assets.

Book-to-market ratio: btm

Besides beta and size, Fama and French's three factor model also includes the book-to-market ratio, which, according to Penman (2003, p. 106), they conjecture to be a factor for risk. Chan, Hamao and Lakonishok (1991, p. 1761) documented a positive correlation between returns and the book-to-market ratio with Japanese monthly data from 1971 to 1988. Their interpretation was that the "noise in reported earnings, related to Japanese accounting standards, may also help to explain why the book to market ratio has such a strong influence." Suda (2004) and Suda, Otomasa and Matsumoto (2004b) use the book-price ratio as a proxy for agency cost and find a negative association with disclosure, but they did not test any association with the cost of equity or the cost of debt. Although it is clear that the book-to-market ratio is important, it is less clear why and how this is so. The book-to-market ratio in the above regression models simply serves as a control variable because of its significant correlation with the WACC.

In order to see if the associations between the variables in Model (1)

remain stable over the 19 year period, panel regressions are performed adding 2 year time period dummy variables to the models. Base period is 1985-1986, and the final period from 2001 to 2003 is three years instead of two.

6.5.2. Model 2

Model (2) tests hypothesis 2 and 3. Dependent variable is the disclosure score (*disc*). The independent variables include leverage, percentage of shares held by foreign investors, by financial institutions, by block-holders, by individual shareholders, and a dummy variable indicating overseas listing.

Capital structure:
Leverage (*lev*) is the ratio of total debt to total assets estimated using the consolidated financial statement data from the NEEDS database. Leverage and disclosure are expected to have a negative correlation because shareholders require more financial disclosure than creditors.

Ownership structure:
Percentages of shares held by foreign shareholders (*for*), financial institution shareholders (*fin*), the largest ten shareholders (*10Lsh*), and individual shareholders (*ind*) are estimated based on unconsolidated financial statement data from the NEEDS database. Based on the theory discussed above, foreign shareholders and overseas listings are expected to have a positive association with disclosure, and block-holders and individual shareholders a negative. Financial institutions are expected to be positively correlated to disclosure.

Overseas listing:
The final independent variable in this regression model is a dummy variable indicating whether or not a company was listed overseas or not, and is called (*d−ov*). It indicates a more active attitude towards international capital markets, and is expected to be positively associated with disclosure.

Model (2) $disc = \beta_0 + \beta_1\, lev + \beta_2\, for + \beta_3\, fin + \beta_4\, 10\,Lsh + \beta_5\, ind + \beta_6\, d\text{-}ov$

In order to assess if the associations between disclosure dependent variable and the corporate governance independent variables remain stable over the 19 year period, panel regressions are performed adding 2 year time period dummy variables to the models. Base period is 1985-1986, and the final period from 2001 to 2003 is three years instead of two. In case the associations are not stable over time, regressions of the cross-sectional data per year will provide insight into the nature of these changes.

Table 4: Regression variables of Model (2)

abbreviation	Name
disc	*Disclosure score*
lev	*Leverage: debt to total capital ratio in book-values*
for	*Percentage shares held by foreign shareholders (unconsolidated)*
fin	*Percentage shares held by financial shareholders (unconsolidated)*
10Lsh	*Percentage shares held by 10 largest shareholders (unconsolidated)*
ind	*Percentage shares held by individual shareholders (unconsolidated)*
d-ov	*Dummy variable indicating overseas listing*

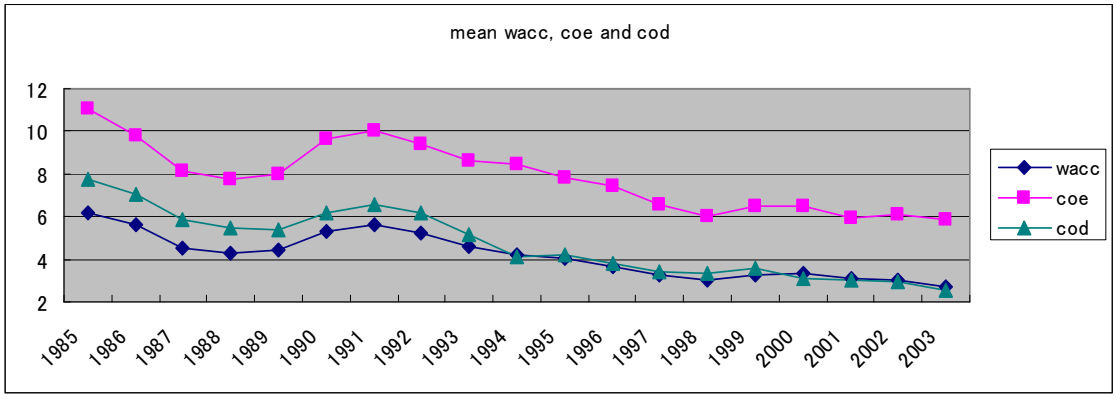
6.5.3. Descriptive statistics

Appendix III, Table B presents a year-by-year statistical summary for all the variables. Below follows an item-by-item discussion of the descriptive statistics.

Cost of Capital

Figure 4 shows that the mean WACC has decreased from 6.1 percent in 1985 to 2.7 percent in 2003. In the same period the mean CAPM cost of equity went down from 11.1 percent in 1985 to 5.9 percent in 2003. The average cost of debt decreased from 7.75 percent in 1985 to 2.53 in 2003. (See Appendix III, Table B, panel a) Two points are particularly interesting to note. First, between 1987 and 1992 WACC means were lower than the 10-yr government bond rates. In other words, the WACC was even lower than the risk-free rate of return. Second, the CAPM cost of equity rose sharply after the burst of the bubble. This rise can be seen in the cost of debt and the WACC as well albeit more vaguely. Nevertheless, after a peak in 1991 all cost of capital measures declined again falling below the 1989 levels in 1995. Such can be considered a consequence of the zero-interest rate policy.

Figure 4: Cost of capital



The JP-GAAP group had a consistently lower mean WACC and cost of debt than the US-GAAP group. The CAPM cost of equity was lower for the JP-GAAP group from 1985 to 1990 after which the US-GAAP group enjoyed a lower CAPM cost of equity. As expected, beta and adjusted beta show the same pattern. (See Appendix III, Table B, panel b) These findings give a preliminary indication that if

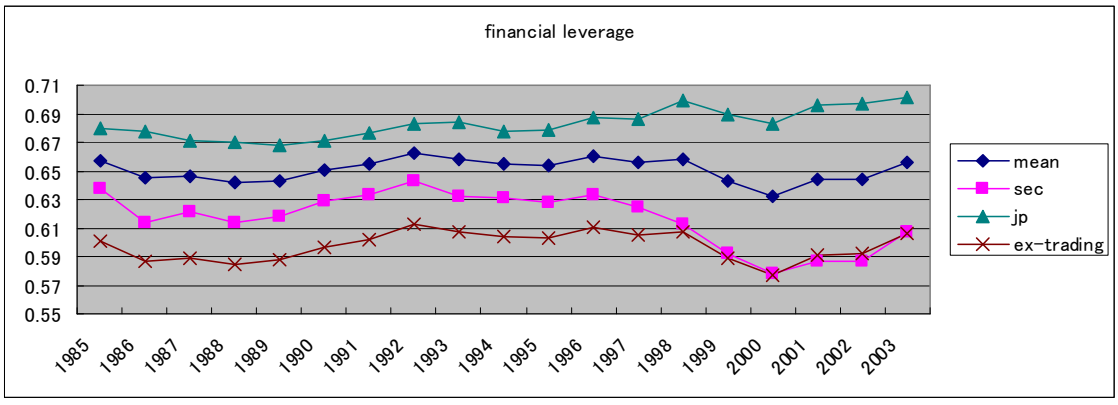
there is a cost of capital benefit to higher disclosure levels, it may be found in the cost of equity but not in the WACC or the cost of debt.

Disclosure level
Average disclosure scores in Appendix III, Table B, panel a show a clear binomial distribution toward the two sub-groups, where that of the US-GAAP group is much higher than that of the JP-GAAP group. From 2000 we see that the disclosure gap closes as the accounting and disclosure standards in Japan are raised.

Size
Company size is characterised by a wide range and a large standard deviation (Appendix III, Table B, panel c). US-GAAP group companies are larger and this difference is significant at the 1 percent level in each and every year. Average firm size increased gradually until 1998 and seems to have declined somewhat since then. This pattern is the same in both sub-groups.

Leverage
Average financial leverage in book-values was 66 percent in 1985, declined slightly to return to 66 percent again in 1990, declined to 63 percent in 2000, but was up to 66 percent again in 2003. Because general trading companies are geared for an average of 98 percent or so, Figure 5 also shows mean leverage without general trading companies as “ex-trading” which is about 5 percent lower than the mean that includes the general trading companies. From Appendix III, Table B, panel c we learn that the range is somewhere between 80 and 90 percent, and the standard deviation about 20 percent. Leverage appears very much to be related to industry. This is one reason why the companies in the sample are matched for industry.

Figure 5: Financial leverage (at book-values)



Looking at Figure 5, we see that US-GAAP group mean leverage is lower than that of the JP-GAAP group. The difference is significant at the 1 percent level in every year. From 1996 to 2000 the gap between the US-GAAP and JP-GAAP groups was widening but since then it has started to close again.

Ratio of book value of equity to market value of equity
Average book-to-market ratios came down gradually from 0.51 to 0.33 between 1985 and 1989. When the asset-inflated bubble burst the average shot straight up to 0.69. After 1996 there is not a clear pattern anymore, but it shows an extreme high in 2002 at 0.82. Until 1996 the average book-to-market ratio was slightly higher for the US-GAAP group, but between 1997 and 2001, the average was considerably lower for the US-GAAP group. The range grows wider in 1991 when the maximum value reaches 1 for the first time, and continues to grow as the maximum grows (Appendix III, Table B, panel c).

Corporate governance variables
The percentages of shares held by foreign, financial, the 10 largest, or individual shareholders show interesting patterns that we can find in Appendix III, Table B, panel d. On average, foreign shareholders held 15 percent of all shares in 1985. This percentage dropped to 7 percent in 1989 and then very slowly started to increase again from 10 percent in 1992 to 20 percent in 2000. Here we see a marked difference in the averages of both subgroups, where the US-GAAP group mean reached 26 percent and the JP-GAAP group mean reached 15 percent.

Financial shareholders held an average of 47 percent of all shares in 1985 and 46 percent in 2003. In the meantime the average was around 55 percent between 1989 and 1991, and then slowly decreased again. The difference between the US-GAAP and JP-GAAP groups is the largest between 1988 and 1990.

The percentage of shares held by the 10 largest shareholders remains fairly stable over time. The only slight decrease is noticeable between 1999 and 2001. The block of shares is around 34 percent for the US-GAAP group and 39 percent for the JP-GAAP group.

Individual shareholders held about 21 percent of all shares in 1985 and about 24 percent in 2003. It looks like individual shareholders were particularly uninterested in the stock market between 1994 and 1998. From the second half of the 1990s individual shareholders held more stock in the JP-GAAP group than in the US-GAAP group.

The dummy variable indicating whether or not a company is listed on an overseas stock exchange is stable over time. We see that most of the companies in the US-GAAP group are listed abroad, whereas many companies in the JP-GAAP group are only listed in Japan.

6.5.4. Correlations
Correlations between all the independent variables of Model (1) and (2) are shown in Table 5 and 6. As expected we find a moderately strong correlation between disclosure and size, between leverage and risk, and between leverage and size.

Table 5: Correlations Model (1)

	disc	adj beta	ln assets	leverage	BTM
disc	1				
adj beta	-0.100	1			
ln assets	0.321	0.189	1		
leverage	-0.068	0.313	0.390	1	
BTM	-0.049	0.074	0.058	-0.086	1

In Table 6 we see that the percentage of shares held by foreign shareholders shows moderately strong negative correlations with financial shareholders and individual shareholders. Block-shareholding is negatively correlated with individual shareholders and overseas listings.

Table 6: Correlations Model (2)

	for sh	fin sh	10Lsh	ind sh	d-ov
for sh	1				
fin sh	-0.423	1			
10Lsh	0.060	-0.053	1		
ind sh	-0.313	-0.384	-0.408	1	
d-ov	0.153	0.135	-0.373	-0.041	1

6.6. Empirical results

6.6.1. Empirical results for Model 1

Table 7 shows the results of the pooled regressions, and Table 8 presents the outcomes of the cross-sectional regressions. Unexpectedly, Table 7, Panels A, B and C all show positive rather than negative associations between the WACC and disclosure that are significant at the 1 percent level. The other variables have the expected signs and are all significant.

Furthermore, the time effects are significant in all periods. This indicates that the WACC has decreased dramatically and the conclusion based on the regressions with pooled data that companies with higher disclosure levels have a higher WACC may need to be fine tuned for some periods. The regressions using a disclosure group dummy variable instead of the disclosure proxy variable produce very similar results. Panel B shows that the only difference are somewhat higher coefficients for the relation between the WACC and disclosure group, and slightly lower t-statistics even though they are all significant. The US-GAAP group did have a higher WACC than the JP-GAAP group.

Table 7: Estimation Results for Model (1): Pooled Data Regressions, independent variable WACC

	Intercept	disc	d-disc	adj beta	ln assets	leverage	BTM	
Panel A: without time- or group-effects (OLS)								
Coefficients	**9.667**	**0.064**		**0.439**	**-0.196**	**-4.570**	**-0.838**	
t Stat	22.584	7.290		3.165	-5.657	-23.019	-8.165	
Panel B. without time-effects, with group-effect (OLS)								
Coefficients	**9.431**		**0.309**	**0.349**	**-0.160**	**-4.597**	**-0.885**	
t Stat	21.161		3.739	2.484	-4.360	-21.890	-8.481	
Panel C: with time-effects, without group-effect (OLS)								
Coefficients	**8.073**	**0.016**		**1.526**	**-0.018**	**-5.430**	**-0.097**	
t Stat	34.248	3.354		18.374	-0.983	-51.143	-1.681	
Time-effects of Panel C								
Period	87-88	89-90	91-92	93-94	95-96	97-98	99-00	2001-2003
Coefficients	**-1.053**	**-0.433**	**-0.249**	**-1.363**	**-1.935**	**-2.618**	**-2.660**	**-2.933**
t Stat	-12.408	-5.262	-2.868	-16.658	-23.662	-31.714	-31.956	-37.062

Model for Panel A: $wacc = \beta_0 + \beta_1 disc + \beta_2\ a\text{-}beta + \beta_3\ ln\ assets + \beta_4 lev + \beta_5\ btm$
Model for Panel B: $wacc = \beta_0 + \beta_1 d\text{-}disc + \beta_2\ a\text{-}beta + \beta_3\ ln\ assets + \beta_4 lev + \beta_5\ btm$
Model for Panel C: $wacc = \beta_0 + \beta_1\ disc + \beta_2\ a\text{-}beta + \beta_3\ ln\ assets + \beta_4 lev + \beta_5\ btm + \beta_6\ d87\text{-}88 + \beta_7\ d89\text{-}90 + \beta_8\ d91\text{-}92 + \beta_9\ d93\text{-}94 + \beta_{10}\ d95\text{-}96 + \beta_{11}\ d97\text{-}98 + \beta_{12}\ d99\text{-}00 + \beta_{13}\ d01\text{-}03$

Looking at the results of the cross-sectional data in Table 8 we find that companies disclosing more information enjoyed a lower WACC in the first three years only. This relation was statistically significant in 1985 and 1986. In the other sixteen years, companies that were more forthcoming with information experienced a higher WACC, and from 1990 to 1995 this relation was significant. Risk and leverage show the expected signs in all years, with adjusted beta being significant in fifteen years, and leverage in all years. The coefficients for size are positive from 1985 to 1989, and significant in the first three years. From 1990 they are negative and only significant from 1994 to 1996. From 1987 to 1991 the association with the book-to-market ratio is positive and significant between 1987 and 1989. In the other years the association was negative, and significant in five out of eleven years, particularly in 2002 and 2003.[166]

There are three things remarkable about these results. Firstly, the outcomes do not support the hypothesis that more voluntary disclosure leads to a lower cost of capital. On the contrary, they give evidence that the WACC increases with higher disclosure levels, and has been higher for the US-GAAP group since 1988. Secondly, the sign of the association of size with the WACC is positive from 1985 to 1989, after which it stays negative. These results are statistically significant in the 1985-1987 and 1994-1996 periods. And thirdly, the negative association of the book-to-market ratio with the WACC since 1992 is somewhat puzzling. Chan, Hamao and Lakonishok (1991, p. 1742) documented

[166] Although residual plots did not indicate a problem with heteroskedasticity, Appendix III,Table C presents the t-statistics based on White's standards errors. Using White's standard error slightly increases the number of years where the results are significant.

“a reliably positive impact on expected returns” based on 1971-1988 data. The results of present study indicate that this relation only holds when expected returns are positive, or when the market is bullish.

These results refute the first research hypothesis and are contrary to the results in Suda, Shutou and Ohta (2004a and 2004b) for both the cost of equity and the cost of debt. Performing the regressions with the cost of equity and the cost of debt will enable comparison with Suda, Shutou and Ohta’s results. Figure 6, 7, 8 and 9 below show the partial coefficients of yearly cross-sectional regressions following Model (1) with dependent variables $wacc$, coe and cod. Appendix III, Tables D and E present the regression results for the regressions on the cost of equity and the cost of debt.

Figure 6 shows that companies with higher disclosure scores enjoyed a lower cost of debt from 1985 to 1987, and a higher cost of debt from 1988 until 2003. Coefficients were statistically significant in 1986, and from 1990 until 1998. Furthermore, we find a negative albeit non-significant association between the cost of equity and disclosure in 1986 and 1987, from 1992 to 1999, and again in 2003. Looking at the influence of the control variables on the cost of capital in Figure 7, we find that larger companies had a higher WACC between 1985 and 1989, but a lower WACC between 1990 and 2003. This was the same for the cost of debt. Larger companies enjoyed a lower CAPM cost of equity in all years except 1988 to 1991.

As can be expected, Figure 8 shows a lower WACC for more highly leveraged companies in all years. Except for the period between 1988 and 1991, leverage increases the cost of equity which is in conformity with finance theory. Leverage and the cost of debt show a negative association in all years except for the periods 1987-1992, and 1994-1996.

The book-to-market ratio and the WACC show a negative association in all years except between 1987 and 1991 in Figure 9. In 1987 and in the period 1992-2001 the cost of equity and the book-to-market ratio were negatively associated. Between the cost of debt and the book-to-market ratio there was a positive association from 1985 to 1991, since then the sign of the association became negative.

Table 8: Estimation results for Model (1), dependent variable: WACC

	Intercept	disc	adj beta	ln assets	leverage	BTM
Panel A:		Cross-sectional regressions (OLS)				
1985	**6.820**	**-0.043**	**1.162**	**0.309**	**-8.447**	**-0.529**
	6.28	-1.76	3.76	2.97	-12.71	-0.95
1986	**5.276**	**-0.039**	**1.277**	**0.296**	**-7.223**	**-0.201**
	5.660	-1.941	4.580	3.493	-13.698	-0.408
1987	**4.579**	**-0.011**	**0.829**	**0.166**	**-5.351**	**1.399**
	4.473	-0.487	1.712	1.754	-10.448	2.192
1988	**4.481**	**0.003**	**0.755**	**0.104**	**-4.303**	**1.761**
	3.811	0.115	1.554	1.046	-6.827	2.007
1989	**4.685**	**0.004**	**0.428**	**0.106**	**-4.086**	**1.840**
	5.628	0.238	1.007	1.308	-7.500	2.245
1990	**8.392**	**0.038**	**0.376**	**-0.069**	**-4.582**	**0.924**
	8.440	1.970	1.020	-0.706	-7.125	1.203
1991	**8.675**	**0.048**	**1.802**	**-0.119**	**-4.896**	**0.127**
	8.303	2.634	3.602	-1.284	-7.530	0.217
1992	**7.473**	**0.043**	**1.561**	**-0.001**	**-5.197**	**-0.705**
	4.738	1.860	2.178	-0.005	-6.590	-1.348
1993	**8.548**	**0.032**	**1.092**	**-0.127**	**-5.133**	**-0.069**
	7.009	2.176	2.034	-1.528	-9.751	-0.192
1994	**8.673**	**0.026**	**1.045**	**-0.127**	**-5.610**	**-0.311**
	8.608	2.300	2.281	-1.947	-13.674	-0.927
1995	**8.751**	**0.022**	**0.757**	**-0.154**	**-5.081**	**-0.223**
	7.843	1.850	1.406	-2.302	-12.011	-0.691
1996	**7.788**	**0.017**	**1.174**	**-0.118**	**-5.298**	**-0.362**
	8.828	1.422	2.623	-2.102	-14.639	-1.042
1997	**6.171**	**0.019**	**1.635**	**-0.082**	**-4.801**	**-0.403**
	8.410	1.610	3.833	-1.639	-15.257	-1.991
1998	**4.640**	**0.019**	**2.130**	**-0.045**	**-4.631**	**-0.259**
	7.140	1.729	6.205	-0.963	-17.277	-1.935
1999	**5.434**	**0.018**	**1.779**	**-0.045**	**-5.321**	**-0.064**
	6.218	0.949	4.440	-0.711	-13.942	-0.863
2000	**5.326**	**0.029**	**1.644**	**-0.033**	**-5.248**	**-0.113**
	6.943	1.015	5.493	-0.556	-16.797	-0.906
2001	**5.497**	**0.046**	**1.700**	**-0.070**	**-4.689**	**-0.354**
	7.001	1.000	7.232	-1.153	-15.993	-2.145
2002	**6.192**	**0.060**	**1.592**	**-0.080**	**-5.395**	**-0.425**
	6.635	0.889	5.989	-1.127	-15.137	-2.432
2003	**6.652**	**0.076**	**1.433**	**-0.093**	**-5.673**	**-0.778**
	6.142	1.008	4.760	-1.160	-13.259	-2.553

Note: T-statistics are in small fonts

Figure 6: Partial coefficients of disclosure regressed on cost of capital variables

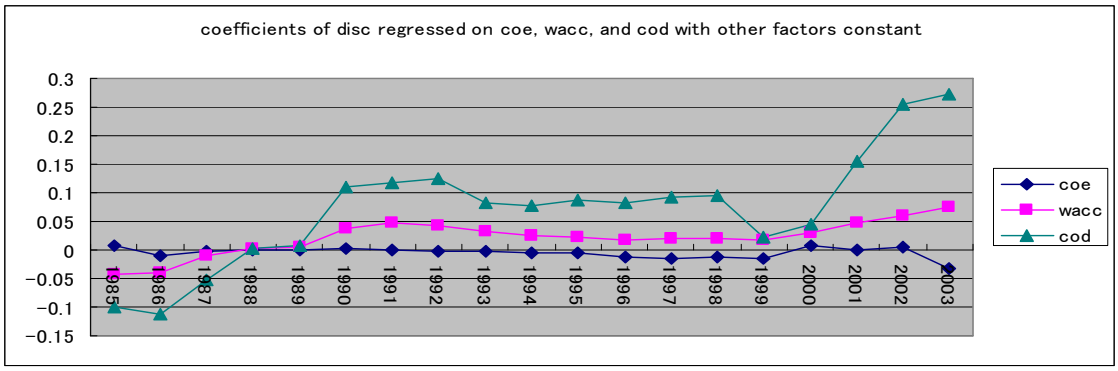


Figure 7: Partial coefficients of size regressed on cost of capital variables

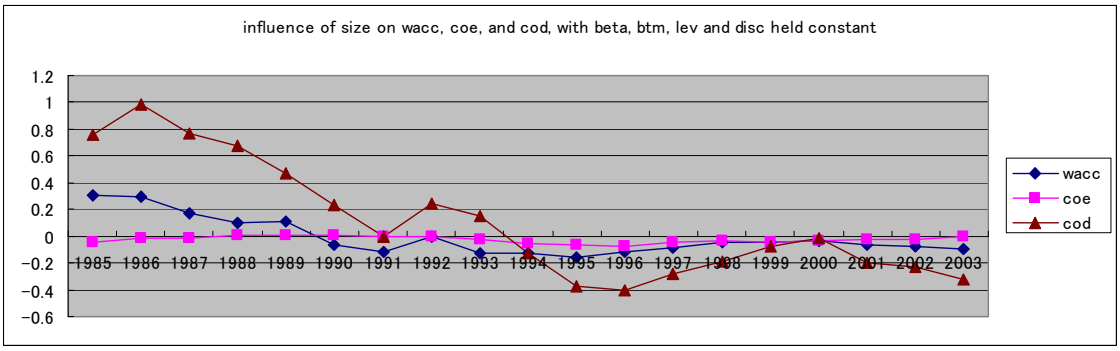


Figure 8: Partial coefficients of leverage regressed on cost of capital variables

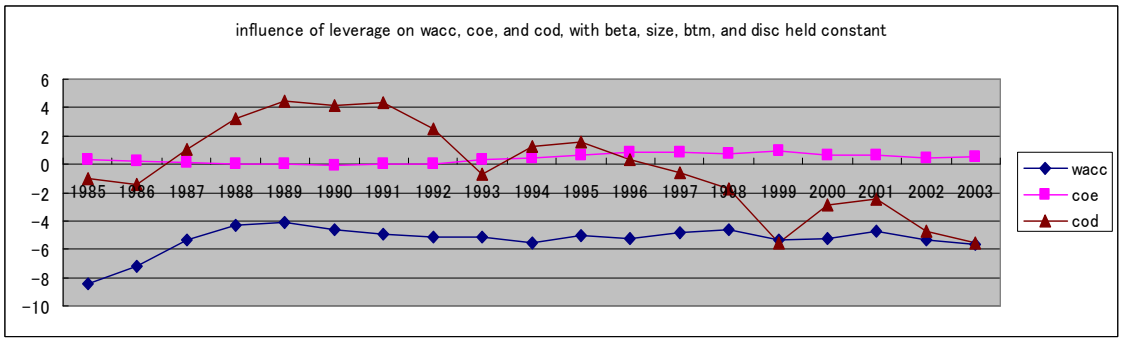
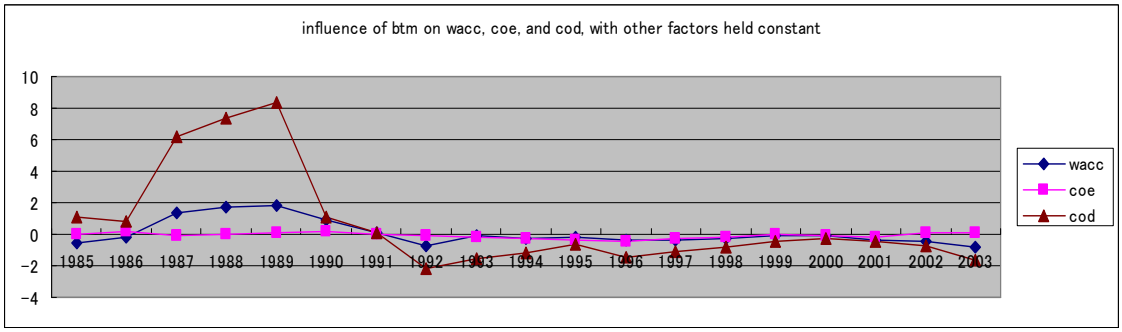


Figure 9: Partial coefficients of the book-to-market ratio regressed on cost of capital variables



6.6.2. Empirical results for Model 2

Table 9 and Table 10 show the regression results for model (2). Table 9, Panel A displays the results when pooled over the whole period from 1985 to 2003, Panel B shows the results with time effects. Table 10, Panel A presents the outcomes of the yearly cross-sectional regressions.

Table 9: Estimation results for Model (2): Pooled Regressions, dependent variable: disc

	Intercept	leverage	for sh	fin sh	10Lsh	indiv sh	d-ov	
Panel A: without time-effects (OLS)								
coefficients	**10.634**	**-3.481**	**0.103**	**2.824**	**-16.458**	**-7.729**	**3.746**	
t-stat	5.725	-5.429	0.062	1.622	-8.018	-3.595	13.629	
Panel B: with time-effects (OLS)								
coefficients	**7.138**	**-2.509**	**7.539**	**3.974**	**-14.695**	**-2.578**	**3.618**	
t Stat	4.108	-4.205	4.507	2.475	-7.754	-1.288	14.280	
Time-effects of Panel B								
	87-88	89-90	91-92	93-94	95-96	97-98	99-00	2001-2003
coefficients	**0.292**	**0.626**	**0.995**	**0.891**	**0.816**	**0.554**	**-1.237**	**-3.793**
t Stat	0.617	1.363	2.010	1.901	1.741	1.178	-2.624	-8.711

Model for Panel A: $disc = \beta_0 + \beta_1 lev + \beta_2 for + \beta_3 fin + \beta_4 10Lsh + \beta_5 ind + \beta_6 d\text{-}ov$

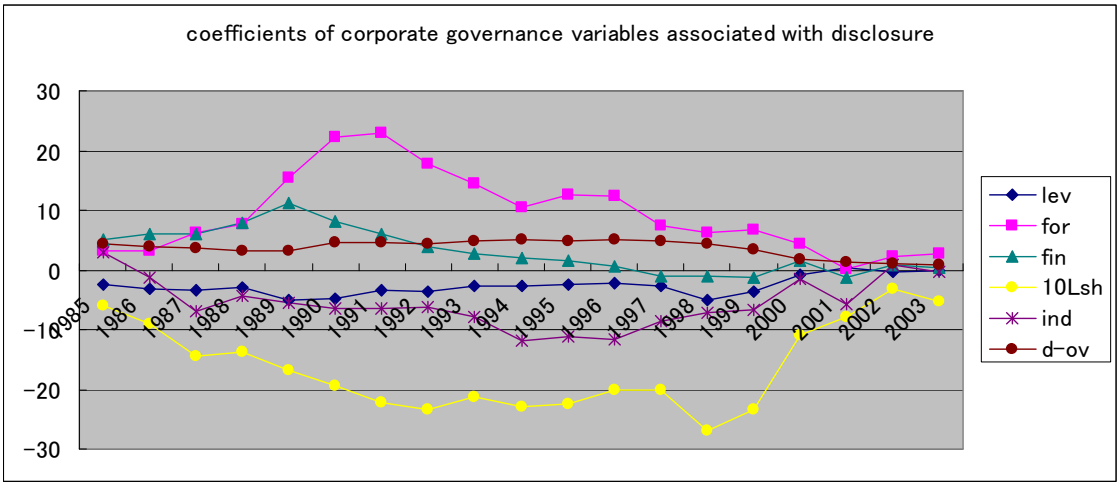
Model for Panel B: $disc = \beta_0 + \beta_1 lev + \beta_2 for + \beta_3 fin + \beta_4 10Lsh + \beta_5 ind + \beta_6 d\text{-}ov + \beta_7 dY87\text{-}88 + \beta_8 dY89\text{-}90 + \beta_9 dY91\text{-}92 + \beta_{10} dY93\text{-}94 + \beta_{11} dY95\text{-}96 + \beta_{12} dY97\text{-}98 + \beta_{13} dY99\text{-}00 + \beta_{14} dY01\text{-}03$

In Table 9, Panel A, we see that leverage, relationship shareholdings and individual shareholdings show a significant and fairly strong negative association with disclosure. Foreign shareholdings show a positive but non-significant association, financial shareholdings a positive association that is only significant at the 10 percent level. Overseas listing status has a positive and significant association with disclosure.

Panel B indicates that the coefficient of the association between disclosure and percentage of shares held by foreign shareholders increases and also becomes significant when controlling for periods. In addition, the coefficient and t-value for the percentage of shares held by financial institutions increase, whereas the significance of individual shareholdings decreases.

Figure 10 is a visual display of the coefficients in Table 10, Panel A. Here is clearly visible that as expected, companies with a higher percentage of their shares held by foreign shareholders disclose more information. Especially between 1989 and 1998 the coefficients were very high. Overseas listing is also positively associated with disclosure over the whole period.

Figure 10: Coefficients of corporate governance variables regressed on disclosure scores



On the other hand, companies with a large percentage of their shares held by block-holders disclosed significantly less information, particularly between 1988 and 2000. Higher leverage, ceteris paribus, was also associated with lower levels of disclosure until 2000. A higher percentage of shares held by individual shareholders too is associated with lower disclosure scores. Interestingly, a higher percentage of shares held by financial institutions is related to higher disclosure between 1985 and 1996, but then the relation changes. From the summary statistics in Appendix III, Table B we understand that between 1987 and 1990 financial institutions held an average of 51 to 56 percent of a company's shares. This is higher than before or after the Bubble period.

Because the residual plots indicate the presence of heteroskedasticity, Appendix III, Table F shows the t-statistics based on White's standard errors. We find that the significance increases for leverage, foreign shareholders, and block-holders after adjustment for heteroskedasticity.

Table 10: Estimation results for Model (2): Cross-sectional Regressions, dependent variable: disc

Panel A:	Intercept	leverage	for sh	fin sh	10Lsh	indiv sh	d-ov
1985	**2.491**	**-2.563**	**3.186**	**5.175**	**-5.908**	**2.832**	**4.279**
	0.261	-0.906	0.461	0.598	-0.632	0.247	3.728
1986	**4.542**	**-3.188**	**3.099**	**6.053**	**-8.952**	**-1.263**	**3.845**
	0.510	-1.159	0.428	0.798	-0.919	-0.114	3.231
1987	**7.934**	**-3.458**	**6.209**	**5.896**	**-14.453**	**-6.826**	**3.592**
	0.993	-1.281	0.854	0.840	-1.661	-0.711	3.184
1988	**5.824**	**-2.989**	**7.685**	**7.940**	**-13.732**	**-4.278**	**3.259**
	0.637	-1.046	0.997	1.036	-1.452	-0.354	2.846
1989	**6.214**	**-4.970**	**15.342**	**11.286**	**-16.816**	**-5.420**	**3.267**
	0.623	-1.610	1.712	1.411	-1.661	-0.423	2.752
1990	**7.845**	**-4.903**	**22.219**	**8.194**	**-19.405**	**-6.536**	**4.654**
	0.753	-1.532	1.666	0.993	-1.850	-0.471	3.842
1991	**9.254**	**-3.399**	**22.942**	**5.956**	**-22.220**	**-6.530**	**4.654**
	0.896	-1.063	1.905	0.688	-2.123	-0.463	3.731
1992	**11.699**	**-3.739**	**17.849**	**3.838**	**-23.301**	**-6.143**	**4.257**
	1.217	-1.174	1.606	0.452	-2.428	-0.481	3.477
1993	**10.845**	**-2.796**	**14.406**	**2.721**	**-21.281**	**-7.812**	**4.819**
	1.005	-0.819	1.215	0.282	-1.975	-0.571	3.587
1994	**12.692**	**-2.686**	**10.540**	**2.009**	**-22.940**	**-11.902**	**5.070**
	1.143	-0.770	0.921	0.201	-2.063	-0.842	3.855
1995	**12.272**	**-2.569**	**12.554**	**1.466**	**-22.403**	**-11.105**	**4.924**
	1.107	-0.818	1.144	0.149	-2.039	-0.793	3.887
1996	**11.262**	**-2.188**	**12.321**	**0.668**	**-20.002**	**-11.654**	**5.069**
	1.012	-0.651	1.129	0.067	-1.797	-0.826	3.967
1997	**12.840**	**-2.647**	**7.332**	**-1.090**	**-20.177**	**-8.630**	**4.731**
	1.196	-0.825	0.740	-0.116	-1.764	-0.708	3.872
1998	**16.959**	**-5.075**	**6.261**	**-1.054**	**-26.958**	**-7.106**	**4.291**
	1.792	-1.745	0.719	-0.122	-2.643	-0.695	3.580
1999	**14.015**	**-3.707**	**6.766**	**-1.242**	**-23.458**	**-6.795**	**3.374**
	1.798	-1.451	0.979	-0.173	-2.801	-0.814	3.360
2000	**5.770**	**-0.763**	**4.292**	**1.564**	**-11.009**	**-1.615**	**1.848**
	1.216	-0.508	1.075	0.370	-2.132	-0.306	2.846
2001	**5.749**	**0.388**	**0.198**	**-1.290**	**-7.953**	**-5.815**	**1.222**
	1.727	0.393	0.076	-0.498	-2.087	-1.555	2.703
2002	**0.687**	**-0.255**	**2.314**	**0.817**	**-3.195**	**0.907**	**1.139**
	0.388	-0.313	1.271	0.448	-1.281	0.666	3.056
2003	**2.050**	**-0.158**	**2.818**	**0.387**	**-5.241**	**-0.442**	**0.825**
	0.932	-0.180	1.442	0.195	-1.653	-0.208	2.003

note: T-Statistics are in small fonts

6.7. Summary and conclusions

In this chapter we have tested associations between cost of capital measures and disclosure scores, and between disclosure scores and corporate governance measures. The first hypothesis was that firms with higher disclosure scores will enjoy a lower WACC. This seems to have been the case in the period between 1985 and 1987, but no longer in the period afterwards. Instead, the association between disclosure and the WACC shows significant and positive coefficients between 1990 and 1998. This outcome goes against the hypothesis

and warrants further study. We have found that between 1990 and 1998 companies with higher disclosure levels had a particularly high cost of debt which was statistically significant. From 1992 to 1999 companies that were more forthcoming with financial disclosure enjoyed a lower cost of equity. However, the coefficients of this relation were not statistically significant. Leverage and WACC show a negative correlation that goes beyond the tax shield advantage.

Looking back at the correlations in Appendix III, Table C, we find that the correlation between the disclosure scores and the cost of capital measures are all positive and that this is the strongest in the correlation with the cost of debt. In other words, companies with higher disclosure scores have a higher cost of debt. This is confirmed by the regression results. On the other hand, the correlation between the disclosure scores and leverage is negative, which means that companies with higher disclosure scores show lower gearing and the other way around. Multiple regression outcomes show the associations between the WACC and disclosure holding the other independent factors constant. The positive association between the WACC and disclosure is therefore not the result of tax benefits due to a lower cost of debt enjoyed by higher leveraged companies that disclose less information. If corporate managers choose to disclose more information publicly but their firms do not enjoy a WACC advantage, a rationale must be found elsewhere. For this purpose we turn to internationalisation, financing and corporate governance factors.

As for the second hypothesis, the findings indicate that companies that are actively raising funds on international capital markets indeed do disclose more financial information. As we have seen in Chapter 5 disclosure requirements on stock exchanges in the US were higher than those in Japan. Although the coefficients for the overseas listings dummy have grown smaller since 2000 because a convergence of the disclosure requirements, they remain statistically significant. In addition, companies where foreign shareholders hold a larger percent of all outstanding shares disclose more information. This association was particularly strong in the period right after the collapse of the bubble economy and gradually grew weaker until its lowest point in 2001. Internationalisation of capital and financial markets has brought about the development of global disclosure standards in Japan. Those Japanese companies that are actively participating in global financial and capital markets could not wait for Japanese accounting standards to catch up and proactively raised the bar. Why these companies chose to be more actively raising funds at international markets is partly explained by shareholder structure and capital structure.

Findings related to the third hypothesis indicate that companies where a large part of the shares is held by the ten largest shareholders, which is thought to be a proxy for relationship shareholding, disclose significantly less information. The coefficients of this association are the strongest between 1989 and 1999, but are significant from 1987 to 2001. It appears therefore that in this period companies whose shares are mainly held by companies within a company group depended on private information exchange rather than public information disclosure, and chose to publicly disclose the legally required minimum amount of financial information. Furthermore, companies that depend more on debt

financing and less on equity financing also have lower disclosure scores, indicating that creditors too must have their information needs met by private exchange. Japanese companies increasingly depend on bonds rather than bank loans, which partly explains the decreasing coefficients of the association between disclosure and leverage. The other part of the explanation is the decreasing disclosure differential due to the convergence in accounting and disclosure standards.

Present study has not tested the direct financing hypothesis in the way Suda, Otomasa and Matsumoto (2004b) have using new the ratio of bond and equity issues to total capital. Nevertheless, from the negative association between disclosure and leverage as well as relationship shareholding, we can deduce that companies more dependent on indirect financing address information asymmetry through private information exchange rather than public disclosure.

In sum, this study has failed to find conclusive evidence for the hypothesis that higher disclosure by Japanese companies issuing their financial statements in accordance with US-GAAP is motivated by a WACC advantage. Rather, there seems to have been a WACC disadvantage to disclosing more information. Like Suda, Shutou and Ohta (2004a), this study finds a negative association between the cost of equity and disclosure between 1996 and 1999 (and in the years 1986-1987, 1992-1999, and 2003 to be precise) although not for the year 2000. But the coefficients are small and non-significant. Bear in mind that their disclosure proxy was the score in the SAAJ reports whereas this study uses a self-constructed proxy based on voluntary disclosure in consolidated financial statements only. Furthermore, Suda, Shutou and Ohta (2004a) estimated the cost of equity based on the “EBO valuation formula”, whereas I use the CAPM cost of equity. Unlike Suda, Shutou and Ohta (2004b), in this study the association between the cost of debt and the disclosure proxy yields positive coefficients. Their estimation of the cost of debt was the yield to maturity on new debt issues whereas I used the ratio of interest expenses to interest bearing liabilities. From a theoretical perspective their estimation method is better than mine, but for most of the period from 1985 to 2003 my method is probably closer to what Japanese managers may have referred to as the cost of debt before taxes.

Firmer conclusions regarding the relation between the cost of capital and disclosure practices require further study over a longer time-span where data is more easily available. Certainly the periods leading up to and right after the collapse of the bubble economy were subject to a degree of market failure and should perhaps not be analysed within the framework of the Efficient Market Hypothesis. Sakaibara *et al*. (1988) found the Japanese capital market to be efficient. If this is true, than private information exchange must be as effective as public disclosure in making a market efficient. It is also possible that the stock market was only efficient for the part that was actually liquid. Depending on the estimates the part of the Japanese stock market was held in mutual shareholding arrangements ranged between 40 to 75 percent. Market efficiency studies comparing capital markets in economies with bank-based financial systems with those in market-based financial systems could yield further insight.

Finally, although not surprisingly, this study finds that actively raising funds at international financial and capital markets and a higher percentage of shares held by foreign shareholders are associated with higher disclosure levels. This is important because it indicates that internationalisation of financial and capital markets leads to convergence of financial accounting standards, or “global standards”. Similarly, internationalisation of product markets causes standardisation of products and related services. The two phenomena may be connected seeing that more companies in the US-GAAP company group are household names in many countries all over the world than companies in the JP-GAAP group. In trying to answer why some Japanese companies choose the costs of higher disclosure levels over the advantages of private information exchange, we find that capital structure (debt versus equity) and ownership structure play important roles. Debt financing is considered risky for creditors, they either require informal information exchange in the case of bank lending, or a high degree of public information supply in the case of the increasingly popular bond financing. Ownership structure predicts disclosure levels based on relationship investing or dispersed shareholder ownership. The former requires lower public disclosure levels because of private information exchange, but the latter requires maximum public disclosure levels in order to solve the information asymmetry and agency problems.

Chapter 7: Conclusion

7.0. Summary

The METI Study Group on the Internationalisation of Business Accounting issued a report in 2004 claiming that the accounting standards under JP-GAAP should be accepted as equal to those under IFRS and even closer to US-GAAP. Part 1 of this study investigated the role of internationalisation of business, financial and capital markets in the process of convergence between JP-GAAP and US-GAAP. Subsequently, Part 2 assessed the extent of the above mentioned convergence. Finally, Part 3 empirically explored economic rationales for voluntary disclosure practiced by Japanese companies between 1985 and 2003. Below follow a discussion of the findings in each of the three parts, and recommendations for further research.

7.1. The role of internationalisation in Japan's financial accounting system development

Part 1 identified four crises that were caused by international political or economic events, and that triggered a response in the form of institutional change affecting financial accounting development in Japan. The first crisis was the threat of colonisation by the West, which prompted Japan's response in the form of rapid modernisation and industrialisation since the Meiji Restoration in 1868. State-led economic development explains the macro-economic policy oriented pattern of accounting development. Japan's choice for a code-law legal system was logical because it facilitated a speedy catch-up by a country that had a tradition of feudalism rather than democracy.

Macro-economic policies centred on investment in heavy industries and infrastructure financed by National Banks and the stock market. The Meiji-Taisho (1868-1926) economy as it is called by Teranishi (2005, p. 41) left corporate financing largely to the market. Direct financing was prevalent in the modern corporate sector whereas the indigenous and agricultural sectors depended on indirect financing through banks and merchants. Taxation was modernised to increase reliance on income tax. Corporate governance was of the shareholder model although in the 1920s there was already a difference between zaibatsu and non-zaibatsu firms. For thirty out of the seventy-seven years between 1868

and 1945 Japan had been involved in ten major wars.[167] In the 1930s the war-economy took shape and aimed at fixed capital formation in munitions industries. Banks and taxation became the vehicle for financing these industries and corporate governance systems increasingly marginalised shareholders for the benefit of other stakeholders such as employees and creditors.

Accounting standards served as a means to calculate taxable income and income for distribution. The Japanese accounting system was characterised by the definite settlement of accounts (*Massgeblichkeit*), the Special Measures Taxation Law, and explicit dividend restrictions for creditor protection. Characteristics of accounting standards at the time include the balance sheet approach to the determination of profits, operating capital maintenance, the all-inclusive concept of profits, and the proprietary concept of ownership. A company was viewed as a legal entity rather than an economic entity, which follows from the fact that accounting standards were set by legal specialists rather than accounting specialists.

The second crisis was Japan's defeat in the Pacific War, as a consequence of which her territory was occupied by the Allied Occupation forces. This was exactly what she had been striving to avoid since 1868. Japan's response was to give the highest priority to economic growth and development. Strong military influence in schools, companies and everyday aspects of life, mixed with Japan's style of Confucianism created a kind of totalitarianism that is exemplified by the *kamikaze* pilots. This was the world that the early post-war generation of managers and business leaders as well as the workers had grown up in. It made for a Japanese style of democracy where all individuals were supposed to work together for the common good without complaining or causing any disharmony. The common good was perceived to be Japan's economic growth and prosperity. In this environment, state-led capitalism worked well.

Economic policy gave priority to fixed capital formation in productive capacity and heavy industries, made possible by directing savings into investment through the main-bank centred financial system. Taxation sacrificed equity for incentive measures and special depreciation measures. The main-bank system made for a stakeholder governance system where shareholders were marginalised, which worked very well in the high-growth period from 1955 to 1980.

In this period the role of financial accounting was limited to the computation of earnings for distribution and taxation and supporting economic policies. Discrepancies between the accounting systems of the Commercial Code and the Financial Statement Regulations under the Securities and Exchange Law dominated academic accounting activity. Many accounting scholars in Japan were more interested in measurement, recognition and creditor protection issues than in the problems concerning disclosure and decision-usefulness of accounting information.[168]

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[167] Taiwan Expedition (1874), Satsuma Rebellion (1877), Sino-Japanese War (1894-95), Russo-Japanese War (1904-05), First World War (1914-19), Siberian Expedition (1918-25), Shantung Expeditions (1927-28), Manchurian Incident (1931-33), China Incident 1937-41), and the Second World War (1941-45). (Morishima, 1982, p. 96).

[168] For a detailed discussion of this schism between Japan's accounting systems see Chapter 3,

The third crisis was cumulative, and because the Japanese government hoped for a soft landing it resulted in the fourth crisis. Internationalisation of financial and capital markets progressed quickly in the 1980s. Trade frictions prompted the Structural Impediments Initiatives, the Yen-Dollar Agreement and the Plaza Accord. Japan responded with piece-meal deregulation.

Economic policy consisted of a loose monetary and fiscal policy, low interest rates and a strong yen due to the Plaza Agreement. When the asset-inflated bubble economy burst an attitude of forbearance exacerbated the problems until the financial system destabilised and the main-bank system crumbled in the second half of the 1990s. By this time financial accounting standards were lagging behind and unable to cope with ongoing developments such as the use of financial instruments and window dressing.

Internationalisation of business, financial and capital markets in the 1980s and early 1990s had pushed Japan into market-capitalism without the necessary institutions functioning as they should. The institutional structure included property rights protection laws, a large stock market, financial deregulation, boards of directors, general shareholders meetings, statutory and independent auditors, and two financial accounting systems plus the strong influence of the tax laws. However, main bank monitoring had hollowed out, the general shareholders meeting had been marginalised, the boards of directors of many large companies consisted mainly of internally promoted directors, and internally promoted representative directors had almost all the power. In addition to that, the emphasis on harmony in Japanese culture does not encourage people to voice criticism, so moral hazard loomed equally large in the period when the speculative bubble inflated as in the period after its collapse.

The fourth crisis occurred when the financial system was discredited and destabilised in front of the whole world. Banks and securities companies went bankrupt, and government bond ratings lowered. This time Japan responded with institutional change, the financial big bang, and the accounting big bang.

Structural and institutional reform started in 1996, as part of which the financial big bang and the accounting big bang came about. The Financial Services Agency took over tasks related to the oversight of the financial system and dealing with the bad loans problem from the Ministry of Finance and was placed directly below the Cabinet Office. Reform of the financial accounting system included first of all measures that helped companies and financial institutions to deal with bad loans in the form of introducing tax effect accounting and temporary measures for land revaluation.

The introduction of fair value accounting for financial instruments, consolidated cash flow statements, making consolidated financial statements the primary statements and expanding the scope of consolidation were meant to unravel mutual shareholdings and make managers take into account the performance of the whole company group. Lifting the ban on holding companies, allowing the purchase of treasury stock, and establishing a system for company tie-ups and split-ups facilitated corporate restructuring and mergers and acquisitions. Giving companies the option of taxation on a consolidated basis

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or for a brief outline the Matrix in Appendix I, Table A.

made it possible to reduce their tax burden. Amendments to the CC in 2001 and 2002 were aimed at improving transparency of corporate governance and gave companies the chance to adopt a corporate governance structure with more outside directors and different committees so as to limit the power of internally promoted representative directors.

In 2001 the Financial Accounting Standards Foundation and the Accounting Standards Board of Japan (ASBJ) were established as the private accounting standard setting body. Accounting standards for the disclosure of post-retirement obligations, financial instruments, and more recently asset impairment improve the disclosure system in order to help investors assess risk more accurately and make better investment decisions. Amendments to the CC have made it possible for part of the legal reserves to be used for capital reduction and to be paid out to shareholders.

All in all the Japanese accounting and disclosure system has been greatly improved and corporate governance has potentially become much more transparent. Nevertheless, the overhaul the accounting system predominantly affects large listed companies. Small and medium-sized companies and even part of the large companies, even if they are joint-stock companies only need to prepare financial statements in accordance with the CC. Therefore, they do not have to prepare consolidated financial statements, audit requirements are a lot less stringent, and corporate governance structures have not become more transparent. On the other side of the spectrum are the companies that have issued their financial statements in accordance with US-GAAP since 1978. These are the twenty-five companies that are voluntarily more forthcoming with information, that for the larger part are less squeamish about proprietary concerns, and that have pro-actively created their own level playing field in the international capital markets before the government decided to do it for them.

When the big bang was more or less completed in 2001, the Enron scandal happened. The American accounting and audit system lost credibility, and the general opinion in Japan was that the Japanese accounting system had certainly achieved international equality and comparability. In 2002 the EU announced that companies using EU capital markets would have to issue financial statements in accordance with IFRS or standards deemed equivalent. It was therefore hard to swallow that Japanese accounting standards would have to be investigated with respect to the question of equivalence. After about a year of complaints from Japanese businesses and efforts by *keidanren*, the FSA and the ASBJ to convince the EU and the IASB that Japan's accounting standards are on par with IFRS, the ASBJ and the IASB have decided to embark on a convergence project in January 2005.

7.2. Convergence between US-GAAP and JP-GAAP

Chapters 4 and 5 concluded that convergence between US-GAAP and Japanese accounting standards has been realised to a certain extent. Purely from an accounting perspective the Japanese accounting big bang was mainly a matter of catching up with international developments in the disclosure of

pension liabilities and assets, fair value of financial instruments, the impairment of assets (from 2007), and the long overdue status of consolidated financial statements including consolidated cash-flow statements. These changes reflect the increased importance of the decision-usefulness of accounting information.

From an economic perspective it was more a matter of removing obstacles created by the definite settlement of accounts principle. The introduction of tax effect accounting meant that companies could present their capital investments and financial results reflecting economic corporate performance rather than taxation measures. From a corporate governance perspective the amendments to the CC improved the position of shareholders versus that of creditors, and gave companies the chance to disperse the power within the board of directors so that there would be more checks and balances. Finally, from an institutional perspective it represents a departure from the traditional legalistic approach where enterprises are predominantly viewed as legal entities instead of economic entities. The new ASBJ is a private accounting regulatory authority. Although it still remains to be seen how the ASBJ's accounting standards will be incorporated into the Commercial Code and how the accounting profession as well as the general public reacts to accounting standards that are not codified.

Based on Chapter 5 we can conclude that the disclosure gap between US-GAAP and JP-GAAP for consolidated financial statements was large between 1978 and 1990. It was even larger between 1991 and 1998, but since then it has narrowed considerably. Because in Japan consolidated financial statements were the secondary statements, disclosure requirements in the form of supporting schedules for individual financial statements were more extensive. New differences between US-GAAP and JP-GAAP are the disclosure of comprehensive income and the requirements by the Sarbanes-Oxley Act. Old differences are recognition criteria for operating and financial leases, disclosures of changes in capital stock and retained earnings, the scope of consolidation, the use of the equity method, the valuation of securities and inventories, accounting for intangibles.

7.3. Economic rationales for voluntary accounting disclosure

Reducing information asymmetry through voluntary disclosure is premised to be motivated by economic rationales. In this study voluntary disclosure is the type of audited information that is voluntarily disseminated irrespective of whether it is good or bad news. Signalling good news could be a motive for voluntary disclosure when a company wants to issue new shares (which in itself is usually considered bad news for existing shareholders), or when a company wants to avoid debt covenants. Signalling bad news is generally done when a company issues a profit warning in fear of litigation. But when a company issues voluntary information irrespective of its nature it either signals supreme confidence or it does not signal anything and is therefore motivated by other concerns.

Reduced information asymmetry through public disclosure lowers estimation risk and transaction costs. Chapter 6 therefore tested the hypothesis

that companies with higher voluntary disclosure levels enjoy a lower weighted average cost of capital (WACC). Disclosure scores on a self-constructed disclosure index were regressed on the WACC controlled for beta (market risk), size, leverage and the book-to-market ratio. Between 1985 and 1989 there was indeed a negative association with the WACC but no longer after 1990. The influence of leverage on the WACC was of course extremely large due to the tax effect. As leverage is also a corporate governance choice, I decided to investigate the relation between disclosure and corporate governance.

Part 2 of this study showed that improvement of financial accounting and disclosure had been an issue in the Structural Impediment Initiative talks. It follows therefore that companies that are more active at international capital markets may be more accommodating toward the information needs of foreign investors. Regressions of leverage, the percentages of the types of shareholders (as an indication of corporate governance influencing disclosure) and a dummy for overseas listing status as independent variables on the disclosure score as the dependent variable showed an overwhelming disparity between percentage of shares held by foreign investors and overseas listings on the positive side, and leverage and the percentage of shares held by the ten largest shareholders on the negative side. In other words, companies that are listed abroad and that have a larger percentage of their shares held by foreign investors indeed show high disclosure scores. Companies that are to a higher degree financed by debt and that have a larger percentage of their shares held by the ten largest shareholders, exhibit lower disclosure scores.

Furthermore, it is very clear that these differences have grown smaller in size and significance since 2000. This is caused because the differences in the voluntary disclosure scores have become very small since 2000. Most of the accounting regulations of the big bang became effective in the year ending March 2000 and to a large extent convergence between JP-GAAP and US-GAAP was realised.

Nevertheless, my tentative conclusion with regard to managers' motivations to voluntarily disseminate financial information regardless of its nature is as follows. Factors related to corporate governance including larger dependence on equity financing, actively raising capital at foreign stock markets and a larger percentage of shares held by foreign shareholders may have outweighed cost of capital considerations. This conclusion applies to the situation in Japan for the period between 1985 and 2003. In order to determine general applicability similar tests need to be carried out in other accounting environments.

7.4. Institutions, information asymmetry and moral hazard

Commensurate with Japan's position as a late developer in the 1870s and again after World War II, the state substituted for the functions of the market to a large extent. The shift from state-led capitalism toward rational (market) capitalism progressed over several decades, spurred on by financial deregulation and internationalisation. Structural reform became unavoidable in 1996, and has

since then taken place at the institutional level in Japan's financial system as well as in her accounting regulatory system. It is now up to the market participants to let financial accounting information fulfil its role in reducing information asymmetry within and across boarders.

This study has shown that the characteristics of financial accounting standards and information change according to the role that information plays. Public disclosure of financial and other information gains in importance in mitigating information asymmetry problems and costs with increased dependence on capital markets. On the other hand, in the case of relationship investing the main purpose of accounting standards is the calculation of distributable income, because information asymmetry problems are addressed through internal communication. As the bad loans and *jusen* problems in Japan and the Enron and other debacles in the US have shown, both systems are vulnerable to moral hazard, dishonesty and even criminal intent. The Sarbanes-Oxley Act has been devised to address these problems in the US, but Japan has not come up with an equivalent as of yet.

The outcome of the empirical study that Japanese companies with higher disclosure levels actually pay a WACC premium goes against theory. My findings that leverage in the JP-GAAP group is still as high as before the year 1998 is disconcerting for two reasons. First, it goes against what is commonly thought to be true. Second, the companies in the JP-GAAP group can only display such high leverage if they are not concerned about bankruptcy costs. If the Japanese financial system has truly been deregulated and geared toward direct financing since the Big Bang, finance theory dictates lower debt to total capital ratios and certainly no WACC premium on higher disclosure levels. Hopefully things have changed since 2004. Perhaps in the future reduced information asymmetry will indeed translate into a WACC advantage. But that is a question for another study.

Globalisation and internationalisation are products of multinational companies and of advances in information technology. Foreign pressure caused Japan to open up her boarders in 1853 and ever since she found herself divided with regard to the question of how to deal with the challenge of assimilating new institutions and technologies without loosing her own culture. She has always found a way to do so effectively although as a consequence of which a dual structure appeared in her economy. In the same way a dual structure appeared in her accounting system. It will be very interesting to watch the developments as the influence of IFRS increases, because most of the complaints voiced by the business community can be regarded as a sign that they do not want to loose their own culture. Will Japan's accounting system ever be truly unified?

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Appendices

Appendix I:

1. Table A. Matrix for Chapter 2
2. Table A. Matrix for Chapter 3
3. Table B. Japanese Long-term Economic Indicators 1885-1940
4. Table B. Japanese Long-term Economic Indicators 1949-2003
5. Table C. Japanese Military Capital Formation 1887-1940
6. Graph A. Official Discount Rates in Japan and the USA1970-2005

Appendix II:

1. Table A. Japanese GAAP Consolidated Disclosure Requirements
2. Table B. US-GAAP Disclosure Requirements
3. Table C. Japanese GAAP Unconsolidated Disclosure Requirements
4. Table D: Disclosure Score Sheet

Appendix III:

1. Table A. List of Sample Companies
2. Table B, panel a. Summary statistics for cost of capital and disclosure variables
3. Table B, panel b. Summary statistics for beta
4. Table B, panel c. Summary statistics for the independent variables of Model (1)
5. Table B, panel d. Summary statistics for the independent variables of model (2)
6. Table C. Estimation results for Model (1), dependent variable: WACC, with T-statistics based on White's standards errors
7. Table D. Estimation results for Model (1), dependent variable: CAPM cost of equity
8. Table E. Estimation results for Model (1), dependent variable: cost of debt
9. Table F: Estimation results for Model (2) with T-statistics based on White's standard errors

Appendix I

Table A: Matrix for Chapter 2

	Matrix 1	1868–1945	1945–1980	1980–1996	1996–2004
2	Environmental Factors				
2.1.	international relations	learning from the West, fukoku kyouhei, war (in total about 30 years over this period) and imperialism (East Asian Greater Prosperity Sphere)	Allied occupation forcing democratisation, technology imports, Korean war and US procurements, oil dependency, Nixon shock, trade frictions, yen-dollar agreement	Plaza Accord, internationalisation of financial markets, inflating the bubble, Gulf war, fall of Berlin wall, collapse of the bubble, JPY90/USD1, 1995 Japan premium	Asian financial crisis (1997), Moody's downgrades Japanese government bonds, Japan's SDF employed in Iraq's reconstruction (2002), tensions with China and North-Korea
2.2.	economic growth and development	start of industrialisation, upswings due to wars, rise of zaibatsu, development of overseas territories, war economy	taming inflation and increase productive capacity in major industries, loose monetary and fiscal policies, 1960s technology rather than cheap labour, savings directed into investment, export promotion, end of Bretton-Woods, 1973 and 1978 oil shocks	slower but stable economic growth, loose monetary policy, low interest rates, asset inflation, bubble collapsed end of 1989, GDP growth down to zero, bad loan problem surfaces, strong yen, slower exports	deflation, bad loans destabilise financial system, government bond rating lowered, announcement of financial big bang, deregulation, some signs of recovery but not very clear
2.3.	financial system	national banks were the means to finance development, stock companies induced need for accounting standards, from 1931 the financial system served more and more the war-economy	strict financial controls until 1970s, compartmentalisation, democratisation of capital markets led to SEL, disbanding zaibatsu by SCAP, overloan and overborrowing, mutual shareholdeing and keiretsu, stocks unattractive for individuals	increasing independence from banks, Plaza Accord: low discount rate, asset inflation, bubble punctured in 1989, bad loan and juusen problem, nikkei came down, denial and forbearance	interest rates near zero, juusen problem addressed, Japan premium, banks in trouble, bank mergers, need for transparency, big bang deregulation, free, fair, and global standards
2.4.	taxation system	tax system became money based, taxes serve military purposes, income tax and corporation tax established; need for accounting rules	Shoup report, soon equity sacrificed for incentive measures, enterprise rationalisation promotion law; special depreciation measures, special measures taxation law, in 1970 deficits emerge	accelerated depreciation gave way to tax credits, differences between tax laws, CC and SEL became more pronounced	reduction of corporate tax rates, from 2004 consolidated taxation for large companies
2.5.	corporate governance structures	zaibatsu and non-zaibatsu dichotomy	main bank system, CC protects creditors rather than shareholders, large KK do not need annual shareholder meeting's agreement	main bank system crumbling, corporate governance void in large KK, slowly increasing importance of shareholders	after big bang shareholders better protected, CC amended for more external directors, auditing
2.6.	Paradigms	from avoiding colonisation to imperialism	becoming an economic power	confusion and forbearance	creating a level playing field
2.7.	Functions of Accounting Standards	modernisation and industrialisation, development of colonies, building a war-economy	resource distribution, directing investment in productive capacity through main banks, dividend restrictions	coping with international developments, piecemeal deregulation	free, fair and global standards, transparency, steps toward full disclosure

Table A: Matrix for Chapter 3

3.1.	Characteristics				
3.1.1.	regulatory authorities	Franco-German system (MOJ), war-time economy, communist influence	SCAP, MOJ and MOF, and BADC	MOJ and MOF, and BADC	MOJ and MOF, and BADC, new: FASF, ASBJ, JICPA, SESC (securities and disclosure)
3.1.2.	standards, rules and regulations	Tax laws and CC, since 1940 also Special Measures Taxation Law	Tax laws (Massgeblichkeit), CC, and SEL; discrepancies (measurement, recognition, capital surplus, provisions, deferred charges, independent audits, distribution of income, and partly unification	Tax laws, CC, and SEL; discrepancies, and further unification	CC, SEL, introduction of tax effect accounting, numbered accounting standards by the ASBJ, Conceptual Framework since 2004
3.1.3.	creditor protection	CC dividend restrictions	dividends restrictions, capital and legal reserves, provisions, deferred charges, no treasury stock allowed	dividends restrictions, capital and legal reserves, provisions, deferred charges, treasury stock restriction relaxation	relaxation of dividend restrictions and capital and legal reserves, reduction of provisions allowed
3.1.4.	status of consolidated financial statements	unconsolidated financial statements only for each and every company (parent or subsidiary)	unconsolidated only until 1978, then consolidated, but only as secondary statements, 1978–1983 equity method not mandatory	consolidated only secondary, unconsolidated disclosure much more extensive, bad loans problem hard to quantify because circumvention of consolidation	2000: under SEL consolidated financial statements main, also consolidated cashflow statements, consolidated interim f/s, consolidated taxation, since 2003 CC introduced consolidation requirement for
3.2.	Accounting Concepts and Approaches				
3.2.1.	determining profits	static; assets at market value	CC: static, SEL: dynamic, in 1962 CC to dynamic, accrual accounting	accrual accounting	accrual accounting, but static approach toward valuing financial instruments
3.2.2.	capital maintenance	operating capital maintenance, CC did not allow retained earnings	CC: operating, SEL: nominal, in 1950 CC shift to financial capital maintenance, since 1962 revaluation reserve as part of capital reserve not allowed	financial capital maintenance	financial capital maintenance, relaxation of capital surplus for distribution in case of marketable securities holding gains and land revaluation holding gains
3.2.3.	definitions of liabilities and equity, and distribution of income concepts	proprietary concept, during the war in practice shift to entity concept	CC: proprietary, SEL(BAP and PSR): entity, in 1974 SEL shift to proprietary concept as a compromise. Actual dividend payout practices inclined toward stakeholder/entity concept	proprietary concept, but director bonuses in distribution of profits. Actual dividend payout practices inclined toward stakeholder/entity concept	increased importance of shareholders in the actual distrbution of income
3.2.4.	clean and dirty surplus concepts	all-inclusive concept of profits	CC: all-inclusive, BAP: operating concept of profits, in 1974 BAP shifts to all-inclusive but demands P/L and surplus statement	all-inclusive concept of profits	all-inclusive concept of profits, international developments on the disclosure of comprehensive income

Appendix I, Table B: Long-term economic indicators

Year		GNE (at market prices (Current prices)	Gross domestic fixed capital formation	Surplus of nation on current account	Exports plus factor income received from abroad	Imports plus factor income paid abroad	Discount rate on commercial bills BOJ	Ordinary savings postal interest	USD/100Y	overall price index 1934-1936 base	percentage of change from the previous year in GNE
明治18年	1885	806	97	-3	42	45	6.94	6.00	81 3/4		
19	1886	800	101	6	55	49	5.84	4.20	72 3/4		-0.7
20	1887	818	100	-8	59	67	5.48	4.20	73 —		2.3
21	1888	866	133	-6	74	80	6.75	4.20	72 1/2		5.9
22	1889	955	141	0	78	78	6.94	4.20	73 1/2		10.3
23	1890	1056	153	-32	65	97	6.57	4.20	74 3/4		10.6
24	1891	1139	160	13	89	76	6.21	4.20	75 —		7.9
25	1892	1125	153	14	102	88	5.84	4.20	65 1/2		-1.2
26	1893	1197	165	-4	100	104	6.21	4.20	54 1/2		6.4
27	1894	1338	220	-15	125	140	7.67	4.20	57 1/4		11.8
28	1895	1552	251	-7	150	157	6.94	4.20	46 3/4		16.0
29	1896	1666	303	-68	135	203	7.30	4.20	49 5/8		7.3
30	1897	1957	402	-101	191	292	8.03	4.20	48 1/8		17.5
31	1898	2194	426	-171	200	371	7.30	4.80	48 1/2		12.1
32	1899	2314	376	12	257	245	6.94	4.80	49 1/4		5.5
33	1900	2414	391	-74	259	333	8.76	4.80	49 —		4.3
34	1901	2484	379	6	310	304	8.76	4.80	49 1/8	0.469	2.9
35	1902	2537	335	16	332	316	6.21	4.80	49 3/8	0.474	2.1
36	1903	2696	366	-14	370	384	5.84	4.80	49 —	0.504	6.3
37	1904	3028	364	-141	383	524	7.30	5.04	48 5/8	0.530	12.3
38	1905	3084	517	-337	401	738	8.03	5.04	49 1/8	0.569	1.8
39	1906	3302	540	-35	540	575	6.57	5.04	49 1/4	0.586	7.1
40	1907	3743	634	-16	617	633	7.30	5.04	49 1/4	0.632	13.4
41	1908	3766	663	-88	506	594	7.30	5.04	49 1/4	0.609	0.6
42	1909	3780	597	-17	539	556	5.84	5.04	49 3/8	0.581	0.4
43	1910	3925	689	-69	587	656	4.75	4.20	49 1/4	0.588	3.8
44	1911	4463	860	-99	619	718	5.48	4.20	49 1/4	0.610	13.7
45	1912	4774	857	-110	727	837	6.57	4.20	49 1/4	0.646	7.0
大正2年	1913	5013	861	-107	844	951	6.57	4.20	49 1/8	0.647	5.0
3	1914	4738	806	-17	799	816	7.30	4.20	49 1/4	0.618	-5.5
4	1915	4991	793	216	1004	788	7.30	4.80	48 7/8	0.625	5.3
5	1916	6148	1035	605	1646	1041	5.84	4.80	50 —	0.756	23.2
6	1917	8592	1816	937	2356	1419	5.11	4.80	50 1/2	0.951	39.8
7	1918	11839	2702	799	3016	2217	6.57	4.80	51 3/8	1.246	37.8
8	1919	15453	2937	333	3242	2909	8.03	4.80	50 5/8	1.526	30.5
9	1920	15896	3596	-111	2984	3095	8.03	4.80	49 5/8	1.678	2.9
10	1921	14886	2868	-273	2065	2338	8.03	4.80	48 —	1.296	-6.4
11	1922	15573	2975	-190	2388	2578	8.03	4.80	47 7/8	1.267	4.6
12	1923	14924	2500	-536	2184	2720	8.03	4.80	48 7/8	1.289	-4.2
13	1924	15576	2929	-689	2665	3354	8.03	4.80	42 —	1.336	4.4
14	1925	16265	2704	-252	3272	3524	7.30	4.80	40 3/4	1.305	4.4
15	1926	15975	2862	-379	2985	3364	6.57	4.80	46 7/8	1.157	-1.8
昭和2年	1927	16293	2892	-131	2981	3112	5.48	4.80	47 3/8	1.099	2.0
3	1928	16506	2743	-135	3033	3168	5.48	4.80	46 1/2	1.106	1.3
4	1929	16286	2815	77	3300	3223	5.48	4.80	46 1/8	1.075	-1.3
5	1930	14671	2322	47	2486	2439	5.11	4.20	49.367	0.885	-9.9
6	1931	13309	1946	-76	2029	2105	6.57	4.20	48.871	0.748	-9.3
7	1932	13660	2030	-13	2466	2479	4.38	3.00	28.120	0.830	2.6
8	1933	15347	2466	-15	3092	3107	3.65	3.00	25.227	0.951	12.3
9	1934	16966	2923	-59	3580	3639	3.65	3.00	29.511	0.970	10.5
10	1935	18298	3346	167	4158	3991	3.65	3.00	28.570	0.994	7.9
11	1936	19324	3622	191	4580	4389	3.29	3.00	28.951	1.036	5.6
12	1937	22823	5661	-568	5401	5969	3.29	2.76	28.813	1.258	18.1
13	1938	26394	7977	-641	5283	5924	3.29	2.76	28.496	1.327	15.6
14	1939	31230	9822	94	6298	6204	3.29	2.76	25.984	1.466	18.3
15	1940	36851	11698	42	7192	7150	3.29	2.76	23.437	1.641	18.0

Source: Chapter 3 of the Historical Statistics of Japan CD-rom, Japan Statistical Association

Note: Amounts in million yen.

Appendix I, Table B: Long-term economic indicators (continued)

Year		GNE (at market prices (Current prices) 3)	Gross domestic fixed capital formation	Surplus of nation on current account	Exports plus factor income received from abroad	Imports plus factor income paid abroad	Discount rate on commercial bills BOJ	Ordinary savings postal interest	USD/100Y	overall price index 1934-1936 base	percentage of change from the previous year in GNE
24	1949	3375	557	-110	217	327	5.11	2.76		208.8	…
25	1950	3947	694	105	469	364	5.11	2.76	361.05	246.8	16.9
26	1951	5444	1035	209	909	699	5.84	2.76	361.05	342.5	37.9
27	1952	6261	1276	69	789	720	5.84	3.96	361.05	349.2	15.0
28	1953	7059	1554	-81	789	870	5.84	3.96	360.80	351.6	12.7
29	1954	7829	1696	-29	854	882	5.84	3.96	360.80	349.2	10.9
30	1955	8622	1703	75	979	904	7.30	3.96	360.80	343.0	10.1
31	1956	9725	2289	-19	1189	1208	7.30	3.96	360.80	358.0	12.8
32	1957	11082	2948	-211	1338	1549	8.40	3.96	360.80	368.8	14.0
33	1958	11520	2939	168	1318	1150	7.30	3.96	360.80	344.8	4.0
34	1959	12926	3435	142	1531	1390	7.30	3.96	359.80	348.3	12.2
35	1960	15487	4670	61	1774	1713	6.94	3.96	359.60	352.1	19.8
36	1961	19125	6370	-339	1860	2199	7.30	3.60	361.80	355.7	23.5
37	1962	21203	7140	-7	2142	2148	6.57	3.60	359.60	349.7	10.9
38	1963	24475	7886	-264	2349	2613	5.84	3.60	362.40	356.0	15.4
39	1964	28917	9389	-147	2889	3036	6.57	3.60	358.80	356.7	18.1
40	1965	31954	9764	366	3563	3197	5.48	3.60	361.40	359.4	10.5
41	1966	36821	11344	499	4165	3666	5.48	3.60	362.90	368.1	15.2
42	1967	43569	13968	-5	4468	4473	5.84	3.60	362.20	374.7	18.3
43	1968	51599	17333	440	5528	5088	5.84	3.60	358.15	377.9	18.4
44	1969	59670	20919	829	6819	5990	6.25	3.60	358.05	385.9	15.6
45	1970	70708	24771	784	8273	7489	6.00	3.60	357.95	399.9	18.5
46	1971	79272	27214	2089	9896	7807	4.75	3.60	315.70	396.7	12.1
47	1972	90651	31298	2141	10377	8236	4.25	3.36	302.50	399.9	14.4
48	1973	111091	40658	50	12126	12076	9.00	3.84	281.00	463.3	22.5
49	1974	132362	45236	-1247	19453	20700	9.00	4.32	301.60	608.7	19.1
50	1975	145654	44870	-95	20255	20350	6.50	3.84	306.15	626.8	10.0
51	1976	164420	48755	1178	23836	22657	6.50	3.84	293.70	658.3	12.9
52	1977	185622	55982	2949	25562	22613	4.25	2.88	241.05	670.8	12.9
53	1978	204404	62147	3625	24105	20480	3.50	2.40	195.40	653.8	10.1
54	1979	221547	70171	-1724	27903	29627	6.25	3.36	241.00	701.5	8.4
55	1980	240176	75821	-2227	35707	37934	7.25	4.08	204.80	826.2	8.4
56	1981	257363	78941	1503	41814	40311	5.50	3.60	221.10	837.7	7.5
57	1982	269629	79987	2119	44479	42360	5.50	3.12	236.75	852.7	5.0
58	1983	280257	79217	5328	43486	38158	5.00	3.12	233.45	833.7	4.0
59	1984	298084	82973	8705	50019	41314	5.00		252.05	831.5	6.4
60	1985	323,541	90168	11,039	46,177	35,137	5.00		201.35	822.4	7.5
61	1986	338,674	94223	13,281	38,058	24,777	3.50		167.04	86.7	4.7
62	1987	352,530	101047	10,561	36,180	25,619	2.50		142.72	86.7	4.1
63	1988	379,250	114749	8,239	37,431	29,191	2.50	1.68	128.01	87.3	7.6
heisei 1	1989	408,535	128168	6,237	42,273	36,036	3.25		138.20	89.3	7.7
2	1990	440,125	142239	4,173	45,863	41,690	5.25		145.14	92.1	7.7
3	1991	468,234	149057	7,547	46,668	39,121	6.00		134.29	95.1	6.4
4	1992	480,492	146782	10,398	47,288	36,891	3.25		126.51	96.7	2.6
5	1993	484,234	142008	10,766	44,109	33,344	2.75	1.56	110.53	98	0.8
6	1994	490,005	138676	9,883	44,270	34,387	1.75	1.00	101.39	98.6	1.2
7	1995	496,922	138099	6,958	45,230	38,272	1.75	0.50	93.83	98.5	1.4
8	1996	509,984	145023	2,539	49,561	47,022	0.5	0.25	109.18	98.6	2.6
9	1997	520,939	146163	5,758	56,074	50,316	0.5	0.25	121.76	100.4	2.1
10	1998	514,595	138330	9,444	55,051	45,607	0.5	0.25	131.19	101	-1.2
11	1999	507,224	133595	7,892	51,144	43,251	0.5	0.10	113.22	100.7	-1.4
12	2000	511,462	134739	7,316	55,256	47,940	0.5	0.08	108.34	100	0.8
13	2001	505,847	130311	3,174	52,567	49,393	0.1	0.04	122.15	99.3	-1.1
14	2002	497,897	120465	6,412	55,829	49,417	0.1	0.02	124.55	98.4	-1.6
15	2003	497,485	119108	7,976	58,882	50,907	0.1	0.01	115.58	98.1	-0.1

Source: Chapter 3 of the Historical Statistics of Japan CD-rom, Japan Statistical Association

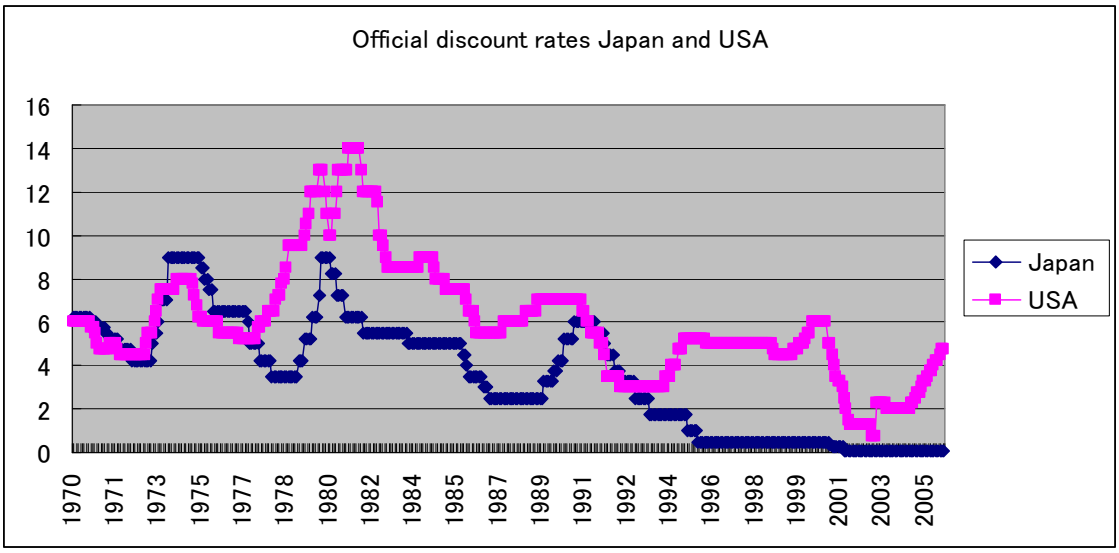
Note: Amounts in billion yen.

Appendix I: Table C: Military Capital Formation

Year		Ohkawa et al GDFCF	MCF	% GDFCF	% growth MCF
明治18年	1885	806	97	7	7.22	
19	1886	800	101	5	4.95	-28.57
20	1887	818	100	5	5.00	0.00
21	1888	866	133	6	4.51	20.00
22	1889	955	141	7	4.96	16.67
23	1890	1056	153	8	5.23	14.29
24	1891	1139	160	8	5.00	0.00
25	1892	1125	153	7	4.58	-12.50
26	1893	1197	165	6	3.64	-14.29
27	1894	1338	220	25	11.36	316.67
28	1895	1552	251	24	9.56	-4.00
29	1896	1666	303	22	7.26	-8.33
30	1897	1957	402	53	13.18	140.91
31	1898	2194	426	63	14.79	18.87
32	1899	2314	376	64	17.02	1.59
33	1900	2414	391	60	15.35	-6.25
34	1901	2484	379	44	11.61	-26.67
35	1902	2537	335	30	8.96	-31.82
36	1903	2696	366	33	9.02	10.00
37	1904	3028	364	59	16.21	78.79
38	1905	3084	517	78	15.09	32.20
39	1906	3302	540	64	11.85	-17.95
40	1907	3743	634	70	11.04	9.38
41	1908	3766	663	80	12.07	14.29
42	1909	3780	597	65	10.89	-18.75
43	1910	3925	689	64	9.29	-1.54
44	1911	4463	860	77	8.95	20.31
45	1912	4774	857	80	9.33	3.90
大正 2年	1913	5013	861	81	9.41	1.25
3	1914	4738	806	86	10.67	6.17
4	1915	4991	793	74	9.33	-13.95
5	1916	6148	1035	75	7.25	1.35
6	1917	8592	1816	139	7.65	85.33
7	1918	11839	2702	228	8.44	64.03
8	1919	15453	2937	290	9.87	27.19
9	1920	15896	3596	377	10.48	30.00
10	1921	14886	2868	429	14.96	13.79
11	1922	15573	2975	356	11.97	-17.02
12	1923	14924	2500	241	9.64	-32.30
13	1924	15576	2929	192	6.56	-20.33
14	1925	16265	2704	243	8.99	26.56
15	1926	15975	2862	199	6.95	-18.11
昭和 2年	1927	16293	2892	202	6.98	1.51
3	1928	16506	2743	220	8.02	8.91
4	1929	16286	2815	187	6.64	-15.00
5	1930	14671	2322	173	7.45	-7.49
6	1931	13309	1946	176	9.04	1.73
7	1932	13660	2030	309	15.22	75.57
8	1933	15347	2466	356	14.44	15.21
9	1934	16966	2923	427	14.61	19.94
10	1935	18298	3346	466	13.93	9.13
11	1936	19324	3622	518	14.30	11.16
12	1937	22823	5661	1607	28.39	210.23
13	1938	26394	7977	3157	39.58	96.45
14	1939	31230	9822	3617	36.83	14.57
15	1940	36851	11698	4195	35.86	15.98

Source: Chapter 3 of the Historical Statistics of Japan CD-rom, Japan Statistical Association

Appendix I, Graph A: Official discount rates in Japan and the USA



Data source: Bank of Japan, downloadable statistics

Appendix II

Table A: JP-GAAP consolidated disclosure requirements

	SEL-consolidated	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1	consolidated B/S	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1
2	consolidated P/L	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1
3	cons. retained earnings statemer	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1
4	cons.cash-flow statement																c-fsr1	c-fsr1	c-fsr1	c-fsr1	c-fsr1
5	statement of changes in stockholders equity																				
6	comprehensive earnings statement																				
7	SS:bonds																	c-fsr1	c-fsr1	c-fsr1	c-fsr1
8	SS-borrowings																	c-fsr1	c-fsr1	c-fsr1	c-fsr1
9	scope of consolidation	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13	c-fsr13
10	N: subsequent events													c-fsr14.2	c-fsr14.2	c-fsr14.2	c-fsr14.2	c-fsr14.2	c-fsr14.2	c-fsr14.2	c-fsr14.2
11	N: additional information	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15	c-fsr15
12	N: segment disclosure									c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2	c-fsr15.2
13	N: leases											c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3	c-fsr15.3
14	N: related party transactions								discl. Or	discl. Or	discl. Or.	discl. Or.	discl. Or.	discl. Or.	discl. Or.	c-fsr15.4	c-fsr15.4	c-fsr15.4	c-fsr15.4	c-fsr15.4	c-fsr15.4
15	N: tax effect accounting															c-fsr15.5	c-fsr15.5	c-fsr15.5	c-fsr15.5	c-fsr15.5	c-fsr15.5
16	N: marketable securities																c-fsr15.6	c-fsr15.6	c-fsr15.6	c-fsr15.6	c-fsr15.6
17	N: derivatives																c-fsr15.7	c-fsr15.7	c-fsr15.7	c-fsr15.7	c-fsr15.7
18	N: retirement benefits																		c-fsr15.8	c-fsr15.8	c-fsr15.8
19	N: claims to uncons. Subsidiaries	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	c-fsr34	cancelled	cancelled	cancelled	cancelled	cancelled
20	N: collateralised assets/liabilities																		c-fsr34.3	c-fsr34.3	c-fsr34.3
21	N: obligations to uncons. Subsidi	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	c-fsr39	cancelled	cancelled	cancelled	cancelled	cancelled
22	N: bills discounted and endorsed	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.3	c-fsr39.3	c-fsr39.3	c-fsr39.3	c-fsr39.3	c-fsr39.3
23	N: contingent liabilities															c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2	c-fsr39.2
24	consolidation adjustment accoun	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40	c-fsr40
25	minority interest	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41	c-fsr41
26	treasury stock	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43	c-fsr43
27	N: provisions related to contracts	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44	c-fsr44
28	N: net assets per share	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2	c-fsr44.2
29	deferred taxes	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45	c-fsr45
30	sales & general administration ex	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55	c-fsr55
31	R&D expenses													?	?	c-fsr55.2	c-fsr55.2	c-fsr55.2	c-fsr55.2	c-fsr55.2	c-fsr55.2
32	N: net profits per share	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2	c-fsr65.2
33	cash-flow statement																c-fsr67-84	c-fsr67-84	c-fsr67-84	c-fsr67-84	c-fsr67-84
34	US-GAAP	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	MOF28	c-fsr87-90	c-fsr87-90
																	interim c-fsr	interim c-fsr	interim c-fsr	interim c-fsr	interim c-fsr

N= note to the financial statements

SS= supporting schedule

c-fsr consolidated financial statement regulations

Disclosure Ordinance

MOF additional regulation

Table B: US-GAAP disclosure requirements

	US-GAAP	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1	B/S	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51
2	P/L	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51
3	retained earnings statement	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51	APB51
4	statement of changes in stockholders' equity																				
5	cash-flow statement	APB19	APB19	APB19	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95	FAS95
6	comprehensive earnings statement														FAS130	FAS130	FAS130	FAS130	FAS130	FAS130	FAS130
7	N: accounting/disclosure policies	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22	APB22
8	N: accounting changes	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20	APB20
9	N: prior period adjustments	APB20	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16	FAS16
10	scope of consolidation	APB51	APB51	APB51	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94	FAS94
11	equity method	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18	APB18
12	N: subsequent events	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5
13	N: collateralised assets/liabilities	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5
14	N: bills discounted and endorsed	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5
15	N: contingent liabilities	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5
16	N: provisions related to contracts	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5	FAS5
17	N: segmental disclosure	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14	FAS14
18	N: leases	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13
19	N: related party transactions	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57	FAS57
20	N: foreign currency translation	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52	FAS52/133	FAS52/133	FAS52/133	FAS52/133	FAS52/133	FAS52/133
21	N: tax effect accounting	FAS37	FAS37	FAS37	FAS96	FAS96	FAS96	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109	FAS109
22	N: marketable securities	FAS12	FAS12	FAS12	FAS12	FAS12	FAS12	FAS12	FAS107	FAS107	FAS107	FAS107	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125
23	N: derivatives/hedging							FAS105	FAS105	FAS107	FAS107	FAS107	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125	FAS125
24	N: retirement benefits	FAS36	FAS36	FAS36	FAS36	FAS87	FAS87	FAS87	FAS87	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106	FAS106
25	N: pensions	APB8	APB8	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87	FAS87
26	N: treasury stock	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43	ARB43
27	N: earnings per share	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	APB15	FAS127	FAS127	FAS127	FAS127	FAS127	FAS127
28	N: R&D expenditures	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2	FAS2
29	N: asset impairment	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS13	FAS114	FAS114	FAS114	FAS114	FAS114	FAS114	FAS114	FAS114	FAS114	FAS114	FAS114
30	N: stock options	APB25	APB25	APB25	APB25	APB25	APB25	APB25	APB25	APB25	APB25	APB25	FAS123	FAS123	FAS123	FAS123	FAS123	FAS123	FAS123	FAS123	FAS123

Appendix II, Table C: JP-GAAP unconsolidated disclosure requirements

	SEL-unconsolidated	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1	B/S	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1
2	P/L	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1
3	proposal to the distribution of earnings	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1	fsr1
4	cashflow statement																fsr1	fsr1	fsr1	fsr1	fsr1
5	SS: marketable securities	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
6	SS: fixed assets	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
7	SS: intangible assets	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108									
8	SS: securities in related companies	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
9	SS: investments in related companies	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
10	SS: loans to related companies	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
11	SS: bonds	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
12	SS: long-term borrowings	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
13	SS: borrowings from related companies	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
14	SS: capital stock	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
15	SS: capital surplus	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
16	SS: earned surplus	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
17	SS: depreciation costs	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108									
18	SS: hikiatekin (provisions/allowances)	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr108	fsr118	fsr118	fsr118	fsr118	fsr118
19	accounting policy	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2	fsr8-2
20	accounting changes	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3	fsr8-3
21	N: subsequent events	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4	fsr8-4
22	N: additional information	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5	fsr8-5
23	N: leases										fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6	fsr8-6
24	N: marketable securities												fsr8-7	fsr8-7	fsr8-7	fsr8-7	fsr8-7	fsr8-7	fsr8-7	fsr8-7	fsr8-7
25	N: derivatives														fsr8-8	fsr8-8	fsr8-8	fsr8-8	fsr8-8	fsr8-8	fsr8-8
26	N: profit or loss from equity method																fsr8-9	fsr8-9	fsr8-9	fsr8-9	fsr8-9
27	N: related party transactions																fsr8-10	fsr8-10	fsr8-10	fsr8-10	fsr8-10
28	N: tax effect accounting																fsr8-12	fsr8-12	fsr8-12	fsr8-12	fsr8-12
29	N: retirement benefits																fsr8-13	fsr8-13	fsr8-13	fsr8-13	fsr8-13
30	revaluation of fixed tangible assets	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42	fsr42
31	N: claims toward unconsolidated subsidiaries	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39	fsr39
32	N: collateralised assets	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43	fsr43
33	N: collateralised borrowings	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57	fsr57
34	N: obligations to uncons. Subsidiaries	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55	fsr55
35	bills discounted+endorsed notes	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2	fsr58-2
36	N: contingent liabilities	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58	fsr58
37	N: sales to related companies																				
38	non-operating income from related companies			fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91	fsr91
39	N: non-operating expenses to related companies			fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94	fsr94
40	N: net earnings per share						fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2	fsr95-5-2

fsr = financial statement regulations

N = note to the financial statements

SS = supporting schedule

Appendix II, Table D

	Disclosure Score Sheet	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1	consolidated B/S																				
2	consolidated P/L																				
3	cons. retained earnings statement																				
4	statement of changes in stockholders equity																				
5	consolidated cash-flow statement																				
6	SS:bonds																				
7	SS-borrowings																				
8	1. scope of consolidation																				
9	2. method of consolidation																				
10	3. differences in period																				
11	4.accounting treatment: asset valuation																				
12	4. accounting treatment: depreciation methods																				
13	4. accounting treatment: hikiatekin																				
14	4. accounting treatment: foreign currency translation																				
15	4. accounting treatment: leases																				
16	4. accounting treatment: hedge accounting																				
17	5. consolidated subsidiaries																				
18	6. amortisation of consolidation account																				
19	7. profit distribution items																				
20	8. scope of cash-flow funds																				
21	changes in disclosure																				
22	N: subsequent events																				
23	N: additional information																				
24	N: segment disclosure																				
25	N: leases																				
26	N: related party transactions																				
27	N: tax effect accounting																				
28	N: marketable securities																				
29	N: derivatives																				
30	N: retirement benefits																				
31	going concern premise																				
32	accumulated depreciation																				
33	breakdown of intangible assets																				
34	accumulated depreciation of intangible assets																				
35	breakdown of deferred assets																				
36	N: claims to uncons. Subsidiaries																				
37	N: collateralised assets/liabilities																				
38	N: obligations to uncons. Subsidiaries																				
39	N: bills discounted and endorsed notes																				
40	N: contingent liabilities																				
41	consolidation adjustment account																				
42	minority interest																				
43	treasury stock																				
44	N: provisions related to contracts																				
45	N: net assets per share																				
46	deferred taxes																				
47	sales & general administration expenditures																				
48	R&D expenses																				
49	N: net profits per share																				
50	Notes to the cash-flow statement																				
51	asset impairment																				
52	others																				
53	total																				

Appendix III

Table A. List of Sample Companies

number	company name	number	company name
2282	nippon ham	2284	itoham
3591	wacoal	3002	gunze
4901	fuji photo	4902	konica
6301	komatsu	6302	sumitomo heavy
6326	kubota	6361	ebara
6501	hitachi	6504	fuji denki
6502	toshiba	6506	yasukawa denki
6503	mitsubishi electr.	6702	fujitsu
6586	makita	6703	oki
6645	omron	6753	sharp
6701	nec	6765	kenwood
6752	matsushita	6770	alps denki
6758	sony	6792	japan victor
6762	TDK	6841	yokogawa denki
6764	sanyo	6845	yamatake
6773	pioneer	6902	denso
6971	kyocera	6952	casio
6981	murata mfg	6945	fanuc
7267	honda	7203	toyota
7751	canon	7731	nikon
7752	ricoh	7753	minolta
8001	itochu	8003	tomen
8002	marubeni	8004	nichimen
8031	mitsui bussan	8020	kanematsu
8058	mitsubishi corp	8063	nissho iwai
8264	itoyokado	8267	aeon

Note: company numbers are as used by the *Japan Company Handbook* (*会社四季報*) and presently also by the NEEDS database.

Table B: summary statistics, panel a

WACC	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	6.1	5.6	4.5	4.3	4.4	5.3	5.6	5.2	4.6	4.2	4.0	3.7	3.3	3.0	3.3	3.3	3.1	3.0	2.7
median	6.2	5.5	4.5	4.2	4.4	5.2	5.3	4.9	4.4	4.1	3.9	3.5	3.2	2.9	3.1	3.0	2.9	2.6	2.4
st-dev	1.8	1.6	1.2	1.0	0.9	1.1	1.0	1.1	1.1	1.2	1.1	1.1	1.0	1.0	1.2	1.1	1.1	1.3	1.3
min	3.0	2.7	2.6	2.5	2.7	3.5	4.0	3.6	2.7	2.2	2.1	1.7	1.5	1.5	1.7	1.6	1.4	1.7	1.3
max	10.1	8.9	8.1	7.3	6.5	7.8	8.3	8.4	7.9	7.7	7.1	6.8	5.9	5.5	6.6	6.3	6.5	7.5	7.7
sec	6.30	5.84	4.79	4.56	4.68	5.58	5.90	5.42	4.73	4.36	4.12	3.77	3.38	3.21	3.50	3.60	3.35	3.32	2.98
jp	*5.97*	*5.33*	*4.31*	*4.03*	*4.19*	*4.97*	*5.35*	*5.04*	*4.43*	*4.10*	*3.90*	*3.61*	*3.17*	*2.85*	*3.09*	*3.08*	*2.88*	*2.78*	*2.48*

COE	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	11.1	9.8	8.2	7.7	8.0	9.6	10.0	9.4	8.6	8.5	7.8	7.5	6.6	6.0	6.5	6.5	5.9	6.1	5.9
median	11.4	10.0	8.1	7.4	7.6	9.4	9.8	9.5	8.6	8.4	7.8	7.4	6.7	5.9	6.4	6.4	5.9	6.1	5.7
st-dev	1.5	1.3	0.9	1.1	1.0	1.3	1.0	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.9	1.0	1.3	1.4	1.5
min	8.0	6.7	6.5	6.2	6.5	7.6	8.5	7.9	7.2	7.1	6.6	6.1	4.9	3.7	3.9	3.6	2.7	2.8	2.6
max	13.3	11.7	10.2	10.5	10.5	12.9	11.9	11.0	10.3	10.1	9.4	9.1	7.9	7.4	8.6	8.6	8.4	8.6	8.6
sec	11.2	10.0	8.5	8.0	8.2	9.9	*10.0*	*9.2*	*8.3*	*8.2*	*7.5*	*7.2*	*6.4*	*5.8*	*6.1*	*6.2*	*5.8*	*6.0*	*5.8*
jp	*10.9*	*9.6*	*7.9*	*7.5*	*7.7*	*9.4*	10.1	9.6	9.0	8.8	8.1	7.8	6.8	6.2	6.7	6.6	6.1	6.2	5.9

COD	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	7.75	7.01	5.88	5.46	5.39	6.17	6.54	6.20	5.13	4.12	4.20	3.81	3.45	3.34	3.60	3.09	3.06	2.92	2.53
median	7.39	6.82	5.69	5.33	5.49	6.15	7.01	6.59	5.22	4.21	4.08	3.74	3.19	3.12	3.06	2.72	2.71	2.31	1.95
st-dev	2.32	2.12	2.38	2.33	1.86	2.03	2.27	2.50	1.63	1.18	1.27	1.26	1.30	1.45	2.45	2.07	1.62	3.47	3.24
min	4.12	2.71	1.48	2.06	1.61	1.65	1.60	1.90	1.75	1.67	1.56	1.29	1.43	0.93	0.99	0.60	0.78	0.53	0.42
max	16.34	15.50	16.41	14.99	10.06	10.86	10.68	16.49	9.22	7.30	7.79	7.56	7.26	9.47	16.05	14.98	11.06	26.19	24.12
sec	7.83	7.13	6.09	5.78	5.67	6.63	7.02	6.67	5.49	4.39	4.50	4.03	3.69	3.71	3.94	3.45	3.32	3.36	2.91
jp	*7.67*	*6.90*	*5.67*	*5.14*	*5.12*	*5.70*	*6.05*	*5.73*	*4.78*	*3.85*	*3.90*	*3.59*	*3.21*	*2.99*	*3.29*	*2.76*	*2.82*	*2.50*	*2.18*

DISC	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	4.73	4.63	4.63	4.69	4.90	5.21	5.58	6.04	5.69	5.92	5.94	6.06	5.92	5.77	4.63	3.90	2.31	1.15	1.13
median	6	6	6	4	4	5	5	6	6	6	5.5	6	6.5	3.5	2	4.5	2	1	0
st-dev	4.20	4.14	4.14	4.25	4.44	4.76	4.96	4.78	5.11	5.21	5.13	5.21	4.84	4.81	4.12	2.36	1.50	1.23	1.28
variance	17.65	17.18	17.10	18.02	19.74	22.68	24.60	22.86	26.14	27.17	26.29	27.19	23.41	23.12	16.98	5.58	2.26	1.51	1.65
min	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
max	12	12	12	12	12	13	13	13	13	13	14	14	13	13	11	8	6	4	4
sec	*8.52*	*8.50*	*8.50*	*8.73*	*9.15*	*9.81*	*10.38*	*10.69*	*10.65*	*11.00*	*10.92*	*11.12*	*10.62*	*10.60*	*8.76*	*6.00*	*3.64*	*2.32*	*2.36*
jp	0.64	0.77	0.77	0.65	0.65	0.62	0.77	1.38	0.73	0.85	0.96	1	1.23	1.30	0.81	1.96	1.07	0.07	0

Table B: summary statistics, panel b

ADJ BET	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	1.03	0.99	0.79	0.66	0.70	0.66	0.82	0.92	0.97	0.97	0.97	0.99	0.95	1.01	1.06	1.06	1.04	1.08	1.11
median	1.11	1.04	0.77	0.59	0.62	0.60	0.78	0.95	0.97	0.97	0.96	0.98	0.97	1.00	1.04	1.04	1.02	1.06	1.06
st-dev	0.34	0.30	0.21	0.24	0.22	0.30	0.22	0.19	0.19	0.17	0.16	0.16	0.15	0.16	0.21	0.23	0.29	0.31	0.33
min	0.35	0.29	0.41	0.30	0.37	0.21	0.48	0.57	0.64	0.65	0.68	0.68	0.57	0.49	0.49	0.42	0.30	0.31	0.38
max	1.54	1.43	1.25	1.29	1.28	1.40	1.25	1.29	1.34	1.33	1.34	1.36	1.24	1.32	1.55	1.54	1.60	1.65	1.73
sec	1.07	1.05	0.86	0.72	0.74	0.72	*0.81*	*0.87*	*0.89*	*0.90*	*0.90*	*0.92*	*0.90*	*0.96*	*0.99*	*1.01*	*1.01*	*1.06*	*1.09*
jp	*0.99*	*0.94*	*0.72*	*0.60*	*0.65*	*0.61*	0.84	0.97	1.04	1.04	1.04	1.05	1.00	1.05	1.13	1.10	1.06	1.10	1.12

BETA	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	1.03	0.98	0.67	0.48	0.53	0.49	0.73	0.87	0.94	0.95	0.94	0.96	0.90	0.99	1.07	1.07	1.04	1.10	1.14
median	1.16	1.06	0.64	0.37	0.41	0.39	0.67	0.92	0.95	0.94	0.93	0.96	0.95	0.99	1.05	1.06	1.04	1.10	1.09
st-dev	0.54	0.48	0.32	0.37	0.34	0.47	0.33	0.29	0.28	0.25	0.23	0.24	0.23	0.26	0.34	0.38	0.47	0.51	0.53
min	-0.01	-0.10	0.09	-0.07	0.03	-0.21	0.19	0.35	0.44	0.47	0.51	0.51	0.33	0.22	0.21	0.10	-0.07	-0.06	0.04
max	1.82	1.66	1.38	1.45	1.42	1.62	1.38	1.45	1.41	1.43	1.39	1.38	1.34	1.50	1.84	1.83	1.93	1.99	2.12
sec	1.08	1.07	0.78	0.56	0.61	0.57	*0.71*	*0.80*	*0.84*	*0.85*	*0.85*	*0.88*	*0.85*	*0.94*	*0.99*	*1.02*	*1.01*	*1.09*	1.14
jp	*0.98*	*0.88*	*0.55*	*0.39*	*0.46*	*0.41*	0.75	0.94	1.04	1.04	1.04	1.04	0.96	1.04	1.15	1.12	1.06	1.12	1.14

Table B: summary statistics, panel c

SIZE	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	13.415	13.441	13.503	13.591	13.731	13.891	13.974	14.009	13.986	13.968	13.995	14.060	14.100	14.139	14.110	14.088	14.116	14.084	14.037
median	13.127	13.184	13.251	13.372	13.493	13.599	13.762	13.792	13.864	13.956	14.023	14.104	14.146	14.218	14.085	14.053	14.113	14.053	13.866
st-dev	1.225	1.184	1.164	1.172	1.204	1.246	1.242	1.216	1.204	1.194	1.196	1.198	1.208	1.203	1.199	1.191	1.208	1.223	1.239
min	11.330	11.460	11.469	11.612	11.750	11.920	12.059	12.053	12.098	12.109	12.118	12.159	12.176	12.188	12.110	12.095	12.096	12.106	11.864
max	15.654	15.569	15.638	15.835	16.068	16.273	16.295	16.144	16.058	16.083	16.157	16.244	16.357	16.444	16.507	16.617	16.679	16.806	16.848
sec	*13.806*	*13.840*	*13.918*	*14.009*	*14.157*	*14.341*	*14.423*	*14.465*	*14.436*	*14.420*	*14.456*	*14.534*	*14.574*	*14.554*	*14.537*	*14.525*	*14.581*	*14.563*	*14.548*
jp	12.992	13.042	13.087	13.172	13.305	13.441	13.525	13.554	13.535	13.516	13.533	13.586	13.626	13.755	13.715	13.683	13.685	13.641	13.564

LEV	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	0.66	0.65	0.65	0.64	0.64	0.65	0.66	0.66	0.66	0.65	0.65	0.66	0.66	0.66	0.64	0.63	0.64	0.64	0.66
median	0.63	0.61	0.65	0.64	0.64	0.66	0.67	0.68	0.68	0.67	0.68	0.69	0.71	0.71	0.67	0.66	0.67	0.69	0.70
st-dev	0.20	0.20	0.20	0.20	0.19	0.19	0.19	0.20	0.21	0.21	0.21	0.21	0.22	0.22	0.23	0.23	0.22	0.23	0.23
min	0.22	0.18	0.19	0.18	0.15	0.16	0.13	0.09	0.10	0.09	0.11	0.10	0.10	0.12	0.09	0.09	0.12	0.08	0.10
max	0.98	0.98	0.98	0.98	0.98	0.96	0.96	0.95	0.95	0.95	0.95	0.96	0.97	0.97	1.00	0.99	0.99	0.99	0.99
sec	*0.64*	*0.61*	*0.62*	*0.61*	*0.62*	*0.63*	*0.63*	*0.64*	*0.63*	*0.63*	*0.63*	*0.63*	*0.62*	*0.61*	*0.59*	*0.58*	*0.59*	*0.59*	*0.61*
jp	0.68	0.68	0.67	0.67	0.67	0.67	0.68	0.68	0.68	0.68	0.68	0.69	0.69	0.70	0.69	0.68	0.70	0.70	0.70

BTM	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	0.514	0.460	0.412	0.369	0.328	0.404	0.531	0.688	0.664	0.559	0.616	0.536	0.616	0.759	0.784	0.649	0.719	0.823	0.745
median	0.471	0.438	0.406	0.360	0.345	0.394	0.529	0.678	0.659	0.571	0.598	0.501	0.596	0.656	0.550	0.551	0.588	0.746	0.693
st-dev	0.187	0.166	0.140	0.119	0.111	0.129	0.165	0.219	0.202	0.165	0.182	0.162	0.244	0.352	0.904	0.491	0.375	0.441	0.309
variance	0.035	0.027	0.020	0.014	0.012	0.017	0.027	0.048	0.041	0.027	0.033	0.026	0.060	0.124	0.818	0.241	0.140	0.195	0.096
min	0.156	0.174	0.183	0.157	0.102	0.163	0.195	0.247	0.288	0.279	0.316	0.275	0.230	0.327	0.111	0.130	0.081	-0.774	0.249
max	0.873	0.901	0.765	0.616	0.602	0.773	1.025	1.314	1.288	0.964	1.074	0.911	1.352	2.070	6.414	2.885	1.842	1.913	1.517
sec	*0.552*	*0.496*	*0.432*	*0.391*	*0.358*	*0.446*	*0.579*	*0.737*	*0.697*	*0.584*	*0.641*	*0.566*	0.609	0.727	0.605	0.555	0.708	*0.828*	*0.796*
jp	0.473	0.425	0.392	0.348	0.298	0.362	0.483	0.638	0.631	0.534	0.590	0.507	*0.623*	*0.789*	*0.960*	*0.738*	*0.731*	0.820	0.698

Table B: summary statistics panel d

for sh%	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	0.15	0.12	0.09	0.08	0.07	0.07	0.08	0.10	0.10	0.12	0.13	0.16	0.16	0.16	0.16	0.20	0.20	0.19	0.19
median	0.14	0.10	0.06	0.06	0.05	0.06	0.06	0.08	0.08	0.10	0.11	0.14	0.14	0.13	0.14	0.19	0.17	0.17	0.19
st-dev	0.12	0.10	0.09	0.09	0.08	0.05	0.06	0.07	0.07	0.08	0.08	0.09	0.10	0.11	0.11	0.12	0.11	0.11	0.11
min	0.00	0.00	0.01	0.00	0.01	0.01	0.01	0.02	0.02	0.02	0.03	0.02	0.02	0.02	0.03	0.02	0.03	0.02	0.01
max	0.67	0.63	0.60	0.58	0.55	0.27	0.28	0.30	0.33	0.36	0.36	0.40	0.45	0.48	0.49	0.51	0.48	0.46	0.50
sec	*0.15*	*0.13*	*0.10*	*0.08*	*0.08*	*0.08*	*0.10*	*0.12*	*0.13*	*0.16*	*0.16*	*0.20*	*0.21*	*0.21*	*0.22*	*0.26*	*0.25*	*0.24*	*0.24*
jp	0.14	0.11	0.08	0.07	0.06	0.06	0.06	0.07	0.07	0.09	0.09	0.11	0.12	0.11	0.11	0.15	0.15	0.15	0.14

fin sh%	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	0.47	0.49	0.51	0.53	0.55	0.56	0.55	0.54	0.53	0.52	0.53	0.51	0.52	0.52	0.51	0.48	0.49	0.47	0.46
median	0.47	0.50	0.51	0.55	0.54	0.55	0.54	0.54	0.54	0.53	0.54	0.52	0.52	0.51	0.50	0.47	0.49	0.46	0.45
st-dev	0.11	0.12	0.11	0.10	0.10	0.09	0.09	0.09	0.09	0.10	0.10	0.09	0.10	0.09	0.09	0.10	0.10	0.10	0.10
min	0.12	0.10	0.11	0.15	0.16	0.19	0.16	0.15	0.16	0.15	0.18	0.16	0.18	0.20	0.22	0.20	0.25	0.21	0.27
max	0.68	0.70	0.70	0.70	0.72	0.73	0.72	0.72	0.73	0.72	0.73	0.71	0.70	0.69	0.68	0.65	0.68	0.65	0.64
sec	0.47	*0.50*	*0.53*	*0.56*	*0.58*	*0.57*	*0.56*	*0.54*	0.53	0.52	0.53	0.50	0.51	0.51	0.51	*0.48*	*0.49*	*0.48*	0.46
jp	0.47	0.48	0.49	0.50	0.52	0.54	0.53	0.53	*0.54*	*0.53*	*0.54*	*0.52*	*0.52*	*0.52*	0.51	0.47	0.48	0.47	0.46

10L sh%	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	0.37	0.37	0.37	0.38	0.38	0.37	0.37	0.37	0.37	0.36	0.36	0.36	0.36	0.36	0.35	0.35	0.36	0.37	0.37
median	0.37	0.36	0.36	0.37	0.36	0.35	0.36	0.36	0.35	0.35	0.35	0.34	0.35	0.35	0.35	0.33	0.35	0.36	0.36
st-dev	0.08	0.08	0.08	0.08	0.08	0.08	0.07	0.07	0.07	0.07	0.07	0.07	0.06	0.06	0.07	0.07	0.07	0.08	0.07
min	0.24	0.23	0.24	0.26	0.27	0.25	0.25	0.24	0.24	0.24	0.24	0.24	0.25	0.26	0.25	0.27	0.23	0.24	0.23
max	0.65	0.65	0.67	0.70	0.69	0.61	0.61	0.61	0.61	0.59	0.58	0.59	0.58	0.59	0.60	0.60	0.62	0.65	0.59
sec	*0.34*	*0.34*	*0.34*	*0.35*	*0.35*	*0.35*	*0.35*	*0.34*	*0.34*	*0.33*	*0.33*	*0.33*	*0.34*	*0.34*	*0.33*	*0.33*	*0.33*	*0.35*	*0.34*
jp	0.40	0.40	0.40	0.41	0.40	0.40	0.40	0.40	0.40	0.39	0.39	0.38	0.38	0.39	0.38	0.37	0.38	0.39	0.39

indiv sh%	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
mean	0.21	0.21	0.22	0.20	0.20	0.19	0.20	0.20	0.20	0.19	0.19	0.18	0.18	0.18	0.19	0.19	0.19	0.22	0.24
median	0.20	0.20	0.22	0.20	0.20	0.19	0.19	0.19	0.20	0.19	0.18	0.18	0.17	0.17	0.18	0.18	0.17	0.19	0.22
st-dev	0.08	0.08	0.09	0.07	0.07	0.06	0.07	0.07	0.07	0.07	0.07	0.07	0.08	0.09	0.09	0.09	0.09	0.14	0.11
min	0.07	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.07	0.07	0.07	0.06	0.06	0.05	0.05	0.05	0.05	0.07
max	0.37	0.41	0.46	0.38	0.40	0.35	0.34	0.33	0.34	0.34	0.34	0.33	0.37	0.38	0.42	0.41	0.51	0.88	0.50
sec	*0.22*	*0.22*	*0.22*	0.20	0.20	*0.20*	0.20	0.20	0.20	0.19	0.18	0.17	0.16	0.16	0.17	0.16	0.17	0.18	0.22
jp	0.19	0.20	0.23	0.20	0.20	0.19	0.20	0.20	0.20	*0.20*	*0.19*	*0.19*	*0.19*	*0.20*	*0.21*	*0.21*	*0.21*	*0.26*	*0.25*

Table C: Estimation Results for Model (1), dependent variable: WACC
T-statistics based on White's standard errors in small font

Year	Intercept	disc	adj beta	ln assets	leverage	BTM
Panel A:		Cross-sectional regressions (OLS)				
1985	**6.820**	**-0.043**	**1.162**	**0.309**	**-8.447**	**-0.529**
	123.72	-2.19	5.53	3.45	-21.64	-1.07
1986	**5.276**	**-0.039**	**1.277**	**0.296**	**-7.223**	**-0.201**
	98.38	-2.48	6.20	4.02	-23.84	-0.50
1987	**4.579**	**-0.011**	**0.829**	**0.166**	**-5.351**	**1.399**
	41.38	-0.71	2.83	2.01	-16.70	3.02
1988	**4.481**	**0.003**	**0.755**	**0.104**	**-4.303**	**1.761**
	32.38	0.17	2.78	1.12	-13.13	3.15
1989	**4.685**	**0.004**	**0.428**	**0.106**	**-4.086**	**1.840**
	74.65	0.31	1.76	1.98	-16.33	3.97
1990	**8.392**	**0.038**	**0.376**	**-0.069**	**-4.582**	**0.924**
	105.65	2.43	1.75	-1.27	-14.52	1.88
1991	**8.675**	**0.048**	**1.802**	**-0.119**	**-4.896**	**0.127**
	105.20	3.17	5.48	-2.29	-13.61	0.36
1992	**7.473**	**0.043**	**1.561**	**-0.001**	**-5.197**	**-0.705**
	51.78	2.19	3.12	-0.01	-17.79	-1.48
1993	**8.548**	**0.032**	**1.092**	**-0.127**	**-5.133**	**-0.069**
	169.02	2.63	3.56	-3.13	-22.81	-0.27
1994	**8.673**	**0.026**	**1.045**	**-0.127**	**-5.610**	**-0.311**
	123.83	0.12	15.64	-8.22	-11.70	-4.25
1995	**8.751**	**0.022**	**0.757**	**-0.154**	**-5.081**	**-0.223**
	223.88	2.37	2.51	-4.50	-27.49	-0.94
1996	**7.788**	**0.017**	**1.174**	**-0.118**	**-5.298**	**-0.362**
	192.59	1.86	3.21	-3.42	-27.55	-1.29
1997	**6.171**	**0.019**	**1.635**	**-0.082**	**-4.801**	**-0.403**
	146.00	2.25	4.88	-2.48	-27.37	-2.51
1998	**4.640**	**0.019**	**2.130**	**-0.045**	**-4.631**	**-0.259**
	106.60	2.34	7.34	-1.33	-25.88	-2.28
1999	**5.434**	**0.018**	**1.779**	**-0.045**	**-5.321**	**-0.064**
	66.54	1.30	6.48	-0.99	-17.93	-1.88
2000	**5.326**	**0.029**	**1.644**	**-0.033**	**-5.248**	**-0.113**
	79.24	1.43	6.35	-0.74	-19.52	-1.21
2001	**5.497**	**0.046**	**1.700**	**-0.070**	**-4.689**	**-0.354**
	109.29	1.30	7.22	-1.57	-18.24	-2.75
2002	**6.192**	**0.060**	**1.592**	**-0.080**	**-5.395**	**-0.425**
	51.79	1.25	6.89	-1.56	-12.24	-3.20
2003	**6.652**	**0.076**	**1.433**	**-0.093**	**-5.673**	**-0.778**
	43.47	1.48	6.96	-1.51	-11.29	-3.41

Table D: Estimation Results for Model (1), dependent variable: CAPM cost of equity

Year	Intercept	disc	beta	ln assets	leverage	BTM
Panel A:		Cross-sectional regressions (OLS)				
1985	**8.554**	**0.007**	**2.755**	**-0.044**	**0.317**	**0.011**
	13.79	0.51	23.74	-0.72	0.80	0.03
1986	**7.139**	**-0.009**	**2.754**	**-0.014**	**0.216**	**0.138**
	13.14	-0.75	26.15	-0.27	0.69	0.48
1987	**6.417**	**-0.002**	**2.838**	**-0.015**	**0.149**	**-0.061**
	23.15	-0.28	34.33	-0.61	1.12	-0.37
1988	**6.316**	**0.000**	**2.854**	**0.003**	**-0.010**	**0.041**
	132.16	0.38	227.77	0.86	-0.40	1.16
1989	**6.359**	**0.000**	**2.854**	**0.004**	**-0.015**	**0.082**
	84.16	0.31	117.62	0.60	-0.30	1.13
1990	**8.040**	**0.001**	**2.830**	**0.012**	**-0.053**	**0.139**
	38.43	0.38	58.50	0.59	-0.41	0.89
1991	**7.931**	**0.000**	**2.860**	**0.000**	**-0.006**	**0.013**
	485.05	0.33	539.23	0.23	-0.57	1.34
1992	**6.958**	**-0.002**	**2.848**	**-0.002**	**0.061**	**-0.092**
	41.81	-0.57	52.29	-0.15	0.66	-1.52
1993	**6.422**	**-0.003**	**2.702**	**-0.024**	**0.280**	**-0.218**
	15.80	-0.62	20.57	-0.77	1.43	-1.62
1994	**6.664**	**-0.005**	**2.525**	**-0.050**	**0.457**	**-0.272**
	12.58	-0.73	14.13	-1.28	1.89	-1.33
1995	**6.443**	**-0.006**	**2.328**	**-0.069**	**0.610**	**-0.332**
	11.06	-0.75	11.05	-1.69	2.43	-1.67
1996	**6.388**	**-0.012**	**1.900**	**-0.072**	**0.849**	**-0.411**
	8.67	-1.08	7.33	-1.33	2.55	-1.21
1997	**5.169**	**-0.014**	**1.858**	**-0.042**	**0.886**	**-0.249**
	7.86	-1.18	7.54	-0.82	3.03	-1.21
1998	**4.212**	**-0.013**	**1.996**	**-0.033**	**0.697**	**-0.137**
	6.46	-1.06	9.43	-0.65	2.48	-0.92
1999	**4.347**	**-0.016**	**2.031**	**-0.043**	**0.949**	**-0.004**
	5.81	-0.94	9.99	-0.73	2.96	-0.06
2000	**4.027**	**0.007**	**2.381**	**-0.037**	**0.665**	**-0.098**
	6.66	0.32	17.04	-0.77	2.79	-0.99
2001	**3.436**	**0.000**	**2.477**	**-0.023**	**0.581**	**-0.158**
	4.81	0.00	19.52	-0.42	2.24	-1.07
2002	**3.218**	**0.006**	**2.575**	**-0.023**	**0.454**	**0.128**
	4.70	0.12	21.41	-0.45	1.76	0.98
2003	**2.686**	**-0.032**	**2.517**	**-0.007**	**0.581**	**0.087**
	3.02	-0.51	16.31	-0.11	1.68	0.34

Note: T-statistics in small font

Table E: Estimation Results for Model (1), dependent variable: cost of debt

Year	Intercept	disc	adj beta	ln assets	leverage	BTM
Panel A:		Cross-sectional regressions (OLS)				
1985	**-2.566**	**-0.099**	**0.742**	**0.755**	**-1.025**	**1.107**
	-0.68	-1.18	0.69	2.09	-0.44	0.57
1986	**-5.190**	**-0.113**	**0.029**	**0.986**	**-1.459**	**0.838**
	-1.47	-1.50	0.03	3.08	-0.73	0.45
1987	**-7.962**	**-0.052**	**0.594**	**0.767**	**1.097**	**6.180**
	-2.04	-0.63	0.32	2.13	0.56	2.55
1988	**-7.949**	**0.004**	**-0.948**	**0.679**	**3.203**	**7.403**
	-2.01	0.04	-0.58	2.03	1.51	2.51
1989	**-5.645**	**0.007**	**-1.464**	**0.467**	**4.488**	**8.334**
	-2.08	0.12	-1.06	1.76	2.52	3.11
1990	**0.832**	**0.110**	**-2.436**	**0.234**	**4.106**	**1.130**
	0.24	1.65	-1.89	0.69	1.83	0.42
1991	**1.488**	**0.118**	**1.945**	**-0.007**	**4.336**	**0.084**
	0.41	1.86	1.11	-0.02	1.91	0.04
1992	**0.972**	**0.124**	**1.008**	**0.245**	**2.463**	**-2.195**
	0.18	1.58	0.41	0.60	0.92	-1.24
1993	**3.237**	**0.084**	**0.867**	**0.146**	**-0.693**	**-1.512**
	0.77	1.64	0.47	0.51	-0.38	-1.22
1994	**5.152**	**0.078**	**0.075**	**-0.123**	**1.268**	**-1.210**
	1.64	2.21	0.05	-0.61	0.99	-1.16
1995	**9.680**	**0.087**	**-1.439**	**-0.372**	**1.556**	**-0.665**
	2.69	2.24	-0.83	-1.73	1.14	-0.64
1996	**10.507**	**0.082**	**-1.055**	**-0.399**	**0.340**	**-1.419**
	3.71	2.16	-0.73	-2.21	0.29	-1.27
1997	**7.187**	**0.091**	**0.819**	**-0.281**	**-0.657**	**-1.080**
	2.77	2.19	0.54	-1.58	-0.59	-1.51
1998	**5.066**	**0.096**	**2.167**	**-0.193**	**-1.692**	**-0.810**
	1.94	2.12	1.57	-1.04	-1.57	-1.50
1999	**6.040**	**0.022**	**2.309**	**-0.073**	**-5.566**	**-0.485**
	1.41	0.24	1.17	-0.23	-2.97	-1.33
2000	**5.381**	**0.044**	**-0.182**	**-0.018**	**-2.902**	**-0.271**
	1.45	0.32	-0.13	-0.06	-1.93	-0.45
2001	**6.863**	**0.154**	**0.558**	**-0.200**	**-2.471**	**-0.456**
	2.39	0.91	0.65	-0.90	-2.30	-0.75
2002	**9.290**	**0.255**	**0.229**	**-0.230**	**-4.749**	**-0.754**
	1.57	0.59	0.14	-0.51	-2.10	-0.68
2003	**10.943**	**0.272**	**0.566**	**-0.320**	**-5.527**	**-1.648**
	1.95	0.70	0.36	-0.77	-2.50	-1.05

Note: T-statistics in small font

Table F: Estimation Results for Model (2)
T-statistics based on White's standard errors in small font

year	Intercept	lev	for	fin	10Lsh	ind	d-ov
Panel A:		Cross-sectional regressions (OLS)					
1985	**2.491**	**-2.563**	**3.186**	**5.175**	**-5.908**	**2.832**	**4.279**
		-9.52	0.98	1.37	-1.70	0.49	4.46
1986	**4.542**	**-3.188**	**3.099**	**6.053**	**-8.952**	**-1.263**	**3.845**
		-12.44	0.95	1.58	-2.57	-0.23	4.05
1987	**7.934**	**-3.458**	**6.209**	**5.896**	**-14.453**	**-6.826**	**3.592**
		-3.81	2.01	1.68	-4.39	-1.29	3.87
1988	**5.824**	**-2.989**	**7.685**	**7.940**	**-13.732**	**-4.278**	**3.259**
		-1.07	1.75	1.99	-3.89	-0.51	3.40
1989	**6.214**	**-4.970**	**15.342**	**11.286**	**-16.816**	**-5.420**	**3.267**
		-3.77	2.78	2.37	-3.26	-0.67	3.33
1990	**7.845**	**-4.903**	**22.219**	**8.194**	**-19.405**	**-6.536**	**4.654**
		-2.69	2.54	1.46	-3.27	-0.76	5.26
1991	**9.254**	**-3.399**	**22.942**	**5.956**	**-22.220**	**-6.530**	**4.654**
		-61.44	3.21	1.05	-3.73	-0.84	5.32
1992	**11.699**	**-3.739**	**17.849**	**3.838**	**-23.301**	**-6.143**	**4.257**
		-35.19	3.15	0.75	-4.13	-0.88	5.04
1993	**10.845**	**-2.796**	**14.406**	**2.721**	**-21.281**	**-7.812**	**4.819**
		-35.08	2.61	0.49	-3.74	-1.17	5.26
1994	**12.692**	**-2.686**	**10.540**	**2.009**	**-22.940**	**-11.902**	**5.070**
		-73.09	2.39	0.38	-4.12	-1.78	5.61
1995	**12.272**	**-2.569**	**12.554**	**1.466**	**-22.403**	**-11.105**	**4.924**
		-93.88	2.91	0.26	-4.06	-1.67	5.72
1996	**11.262**	**-2.188**	**12.321**	**0.668**	**-20.002**	**-11.654**	**5.069**
		-72.57	2.94	0.12	-3.82	-1.77	5.67
1997	**12.840**	**-2.647**	**7.332**	**-1.090**	**-20.177**	**-8.630**	**4.731**
		-79.20	1.97	-0.21	-3.43	-1.58	5.43
1998	**16.959**	**-5.075**	**6.261**	**-1.054**	**-26.958**	**-7.106**	**4.291**
		-310.13	1.98	-0.20	-4.63	-1.65	5.20
1999	**14.015**	**-3.707**	**6.766**	**-1.242**	**-23.458**	**-6.795**	**3.374**
		-139.72	3.06	-0.27	-5.00	-2.18	4.90
2000	**5.770**	**-0.763**	**4.292**	**1.564**	**-11.009**	**-1.615**	**1.848**
		-9.17	2.41	0.63	-3.23	-0.68	3.96
2001	**5.749**	**0.388**	**0.198**	**-1.290**	**-7.953**	**-5.815**	**1.222**
		2.51	0.19	-0.80	-3.73	-3.96	3.98
2002	**0.687**	**-0.255**	**2.314**	**0.817**	**-3.195**	**0.907**	**1.139**
		-0.51	2.30	0.60	-2.09	1.18	4.44
2003	**2.05**	**-0.16**	**2.82**	**0.39**	**-5.24**	**-0.44**	**0.82**
		-1.79	2.50	0.25	-3.03	-0.34	3.13

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