Accounting Standard Reforms in Postwar Japan

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1. Scope and Key Terms

The objective of this paper is to provide an overview of the postwar changes to Japan's accounting standards[1]. There are three key terms to the topic, each associated with a particular postwar period. They are as follows. (i) *Catching up with the US and European accounting systems*, during the period when efforts were focused on integrating a new Securities Exchange Law (SEL) accounting system with the Commercial Code (CC), which dated back half a century to the prewar era. (ii) *The accounting Big Bang*, during the period when extensive efforts were made to develop standards aimed at completing postwar reforms so as to enhance the international presence of the Japanese capital markets. (iii) *Global convergence*, corresponding to the period during which various options were explored for charting Japan's course amid international trends towards the integration of accounting standards.

No social system, including systems of accounting standards, is immune to path dependency. Every system is under the influence of the domestic economic environment and of any associated legal and regulatory systems, which are likely to differ from country to country. In this sense, the postwar history of Japan as discussed here is a consequence of the path toward modernization that the country took in the prewar era beginning with the Industrial Revolution (also known as the Meiji Restoration) and the problems resulting from it. Japan's most recent history has also been constrained by its postwar path in various ways. For want of space, however, this paper will not venture into the details of this idea. Publications in English that discuss Japan's postwar accounting system with reference to particular qualities or periods include Benston et al. (2006), Suzuki (2007a), (2007b), and Saito (2008).

2. Modernization of Accounting Standards: Catching up with the West

Japan's pre-World War II business accounting system largely rested with the CC, which was under the influence of Continental Europe. However, this does not necessarily mean that businesses relied solely on bank loans to meet their funding needs during the prewar era. On the contrary, stock and bond markets already accounted for a substantial part of fund procurement by businesses before the war regime[2]. Against this backdrop, the postwar reform began with the effort to graft a disclosure system based on a US-style SEL onto the CC. This move itself did not intend to switch Japan to direct financing. Rather, it is said to have been intended to address a range of issues, including the democratization of securities markets as a means to secure funds for industrial rehabilitation through improvements to financial

[1] This historical overview covers the period up to the end of 2007. However, as far as the assessment of equivalence by Europe, one of the most important among all issues relating to convergence for Japan, is concerned, the coverage will be extended to the end of 2008.

[2] See Okazaki & Okuno-Fujiwara (1999), Hoshi & Kashyap (2001), Chap.1, Miwa & Ramsyer (2002).

disclosure[3]. At any rate, the modernization of the accounting system in Japan did not suddenly begin after the war. The prewar initiatives, including the Working Rules for Financial Statements drafted by the Ministry of Commerce and Industry (1934) and the Draft Standards for Financial Statements for the Manufacturing Industry created by the Planning Bureau (1941), were more fully implemented after the disruption caused by the war.

As far as the accounting system is concerned, the driving force behind the reform was the Investigation Committee on Business Accounting Systems (now called the Business Accounting Council), which was established in 1947, a year before the introduction of the SEL[4]. In 1948, the old registered public accountant system was replaced with the certified public accountant (CPA) system, which enabled front-line implementation of the audit system. In 1949, the Investigation Committee on Business Accounting Systems released its Business Accounting Principles and Working Rules for Financial Statements as guidelines for the disclosure and auditing of financial information. These regulatory rules were also meant as tools that could be used to seamlessly integrate the two accounting systems, one based on the CC and the other on the SEL. This was seen as the greatest challenge of the postwar reforms, an attempt to standardize auditor qualifications under the two accounting systems and unify the criteria used to audit financial statements by incorporating the SEL-based CPA system into the CC.

From the outset, the CC-based accounting system was focused on both disclosure regulation, aimed at ensuring investor access to company information, and dividend restrictions, aimed at coordinating the interests of the two classes of investors, creditors and shareholders. The hope was to prevent the dilution of the original value of creditors' claims due to the payment of dividends to shareholders. The aim of the latter was essentially to confirm the actual existence of net firm assets and to limit dividend payments to the portion that exceeded legal capital (stated capital and most of capital surplus); i.e., retained earnings. These two viewpoints shaped the CC-based accounting system through mutual influence. This resulted in an emphasis on the conservative valuation of assets that rejected upward bias and demanded disclosure through balance sheets and property inventories.

The SEL-based accounting system, on the other hand, primarily focused on the disclosure of information to potential investors. The value of a company that an investor intends to invest in is a function of its expected future business performance, and ongoing and recurring earnings constitute useful information in such estimations. What is in general use here is a mechanism whereby the valuation of assets on the balance sheet is linked to the

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[3] See the preface to the Business Accounting Principles published in 1949. There are a number of Japanese-language publications that discuss the establishment of the Business Accounting Principles and its subsequent revisions, including Kurosawa (1960).

[4] Initially, this body was established under the Economic Stabilization Board. However, it was transferred to the Ministry of Finance in 1952 and subsequently passed on to the Financial Services Agency during the reorganization of government ministries and agencies.

measurement of income on the income statement, with cash flow acting as an anchor. In this way, the SEL stance is contrary to the approach taken by the CC, which focuses on the value of assets. The postwar reforms were instrumental in reconciling their differences and unifying the SEL and CC-based systems by incorporating the former into the company law regime of the CC. In modern terms, this state of affairs exemplifies the tensions between the asset-liability view and the revenue-expense view. These two views, however, are by no means mutually exclusive. In the real world, it is important to achieve the optimum balance between these two views.

Viewed from another angle, the above process was also a unique example of how to reconcile the German-style reporting system (CC) and the American-style disclosure system (SEL) in a single country. In concrete terms, the process involved incorporating SEL-based accounting standards (Business Accounting Principles) into the CC. Thus, the legislation surrounding the Business Accounting Principles was sought through several rounds of CC amendments, because the CC was seen as a mandatory statute. Conversely, however, the Business Accounting Principles rather than the CC were sometimes amended because of the same reason. This process was more or less completed with the 1974 amendment to the CC. At the same time, the historical role of the Business Accounting Principles, which drove the postwar reform of the accounting system in Japan, came to an end. Nevertheless, the accounting system continued to evolve in response to market demands, and the task to amend the CC accordingly remained relevant until 2005, when the Corporate Law, a newer version of the CC, was enacted.

Although the amendments to the CC were diverse, all designed to unify business accounting systems, the points of particular importance were the abolition of property inventories and changes in asset valuation standards. As its name suggests, a property inventory was an itemized list of assets and liabilities, and it was required in addition to a balance sheet. Each item was accompanied by its market value as of the end of the accounting period, and there was no link to income determinations. Although it lacked a net asset section, this statement was otherwise quite similar to a balance sheet and could be viewed as a balance sheet based on an extreme version of the asset-liability approach. If information on all assets and liabilities measured at fair market value is really that useful, then Japan may simply have to revive the use of this type of inventory as a separate report. Partly due to changes to asset valuation rules, however, the property inventory was downgraded to a balance sheet outline in the 1962 Code, and it was eventually abolished altogether by the 1974 Code (except for use during liquidation).

Asset valuation standards as indicated in the CC underwent repeated changes dating right back to the prewar era. The initial 1899 Code required that all classes of assets, including movables, immovables and liabilities, be accompanied by their current value at the time of preparation of a property inventory, and this value was generally understood as the market value. However, there was a shift to valuation based on below-market value, and other schemes soon followed, with an acquisition cost-based valuation scheme gradually gaining ground. Eventually, the 1962 Code settled on valuation based on acquisition cost as a unified valuation scheme for joint stock companies in line with the Business Accounting Principles. The 1962 Code also expanded deferred items, which were introduced by the 1938 Code partly due to the influence of the German Stock Corporation Law (Aktiengesetz) of 1937, with items including startup expenses and discounts on issuing bonds recognized. The initiative was designed to bring deferred items in line with the Business Accounting Principles, and development costs and experiment and research expenses were newly included. The concept of provision was also introduced as a conditional liability.

The coordination between the CC and business accounting as discussed above mainly applied to non-consolidated financial statements because the CC, by its nature, had to regulate accounting on the basis of a legal entity, particularly in areas such as dividend restriction. Meanwhile, deliberations on consolidated financial statements proceeded separately, and their disclosure became mandatory in 1976 through an SEL regulation, partly due to the public outcry over profit manipulation by parent companies through the transfer of losses to their subsidiaries (i.e., window-dressing). Even then, consolidated financial statements were given subordinate status to non-consolidated financial statements and were mere summaries compared to the elaborate financial statements of parent companies that were prepared on a legal entity basis. For consolidated financial statements to become the main focus, the accounting Big Bang (to be discussed later) had to occur.

Subsequently, moves to reform accounting standards in response to changing domestic and international environments accelerated, both within and beyond the framework of the Business Accounting Principles, as with the mark-to-market valuation of financial instruments, and this created new friction between the CC and the SEL. At this juncture, the deadlock regarding the unification of accounting systems was broken by the publication of a study called A Report of the Study Committee on Coordination between the Commercial Code and Business Accounting, jointly prepared in 1998 by the Ministry of Justice, which was in charge of the CC, and the then Ministry of Finance, which was responsible for the SEL. This groundbreaking report suggested that there were cases where, even under the CC-based accounting system, SEL-based accounting standards could be applied to listed companies subject to the SEL, in light of good business accounting practices. This was the case without an express CC provision, provided that no mandatory provision of the CC was violated.

This paved the way for the mark-to-market valuation of some financial instruments, which had been a demand of the time, and tax effect accounting, which was partly intended to encourage financial institutions to write off their bad debts under the CC. It also led to the mandatory application of those measures to listed companies and other entities under the SEL-based accounting system. Furthermore, it made it possible to turn research and development costs, which the CC allowed to be recognized as assets, into expenses as accrued under new Japanese accounting standards in line with US accounting practice. After the 2002 amendment, the CC enjoyed the flexibility to change provisions related to business accounting without going through amending the law by moving those provisions from the code itself to ministerial ordinances. Finally, the new Corporate Law of 2005 stipulated that preparation of financial statements "shall conform to" (as opposed to "shall take into account", as previously stated) generally accepted business accounting practices. This step more or less completed the unification of business accounting systems, which had taken a half-century and a better part of the postwar period[5].

3. Accounting Big Bang: Completing Stage of Postwar Reforms

During the 1990s, after the economic bubble of the late 1980s burst, Japan experienced a prolonged period of economic stagnation, followed by an economic revival project based on efforts to rebuild the Japanese financial markets and transform them into international markets comparable to those in New York or London. This period of financial reform was intended to imitate the "Big Bang" that had taken place in the UK 10 years earlier. In terms of accounting standards, there was still much work to do before Japan could catch up with the West, although progress had been made in the 1980s in areas including futures/options trading, leasing, and foreign exchange. Within this context, a fast-paced program of accounting standard reforms was set in motion to create an accounting "Big Bang." With the heavy lifting done by the Business Accounting Council, these reforms would constitute the finishing touches on the postwar reforms, intended to help Japan catch up with the West under the aforementioned government initiative. With this last reform effort, Japanese accounting standards finally reached a level similar to those of the West despite some differences.

The first step in the reform process was a revision of the accounting standards aimed at switching from non-consolidated to consolidated-focused financial reporting (1997). In the following year, the consolidation rules were amended whereby effective control was added to the long-standing 50%+ equity share ownership as a criterion for consolidation. As a result, the inclusion of an invested company into consolidated financial statements became compulsory as long as the investing company was considered to effectively control the majority votes by virtue of its close relationship through the supply of funds, business transactions, etc., even if its share ownership fell short of 50%. This meant that any evidence of the investing company's having control over the decision-making of an invested company could become a basis for consolidation, regardless of the size of equity share ownership. Around this period, awareness of the need for an effective control criterion spread across the

[5] In the area of dividend restriction, some additional changes are made to the financial data compiled for disclosure purposes as deemed appropriate.

world, but the new Japanese standards, which epitomized this concept, may have been the most progressive at that time in terms of the scope of consolidation they stipulated.

This emphasis on consolidation, however, did not mean abolishing the disclosure of non-consolidated information as in the United States; the provision of both consolidated and non-consolidated financial statements was still required under the SEL. As a result, it was aimed in Japan at improving the reliability of reports prepared specifically for taxation, dividend restrictions and other purposes by linking them to financial statements to be disclosed to investors. Another aim was to reduce various administrative and transaction costs for taxation, governance and other processes by free-riding on accounting procedures and CPA audits. Measures intended to address both of these aims were consciously incorporated into the Japanese accounting system. This gave rise to a kind of triangular system that combined the CC, tax law and accounting standards; the use of multiple alternative accounting procedures, if tolerated by tax law, was permitted provided that they were incorporated into the final settlement of accounts based on the CC, whereas the SEL-based accounting standards were reflected in the CC-based accounting system[6].

New accounting standards were also established for financial instruments that were fundamentally consistent with US standards (i.e. FAS 105, 107, 114, 115, 118 and 119). Previously, the historical cost method was used to measure the value of assets, and book values were written down only when unrecoverable losses occurred. However, this made dubious practices possible, including the much-criticized arbitrary realization of capital gains on securities, intended to camouflage fluctuating business results. The 1999 Accounting Standards for Financial Instruments set rules for mark-to-market valuation with immediate profit recognition for those held for trading, mark-to-market valuation without immediate profit recognition for those (tradable but) not held for trading, and devaluation for loans receivable. It also clarified mark-to-market valuation and hedge accounting procedures for derivatives. Financial investments (instead of financial instruments) seeking capital gains should then be accounted for at their fair values in terms of profit recognition. This marked the adoption of mark-to-market accounting procedures in Japan that were ahead of international standards.

The 2002 accounting standards on impairment of long-term assets, compared the US (i.e., FAS 144) and international standards (i.e., IAS 36) and adopted superior provisions from

[6] In Japan, consolidated financial statements were also incorporated into dividend restriction (in CC). The Corporate Law of 2005 introduced a provision banning dividend payments for the difference between shareholder equity as shown in consolidated financial statements and that shown in non-consolidated financial statements when the former was smaller than the latter (see Section 158-4, Order of the Ministry of Justice on Corporate Accounting). The objective of this provision was to limit dividend payment to the consolidated or non-consolidated surplus, whichever was smaller. This can be interpreted as the application of equity method only on the downside. While this practice ensures a tight link between consolidated and non-consolidated information, it prevents the use of IFRS for consolidated financial statements without using them for non-consolidated financial statements, a convenient method employed in some European countries.

both of them. Japan employed the US standard for recognizing impairment because it provided an effective guard against premature judgments of impairment based on comparisons between undiscounted future cash flows and book values. However, Japan favored the international standard for measuring impairment, using the recoverable amount rather than the fair value. The rationale for the latter provision was that immovable assets used for business operations were not held for the purpose of sales and were therefore not amenable to market valuation. Asset impairment accounting was considered to be an exceptional process designed to write off the unrecoverable portion. Being normally internal information, the recoverable amount would be disclosed in abnormal situations in which it was below the book value rather than merely for the sake of asset valuation. The Japanese standard banned the reversal of impairment losses even in the event of an increase in the recoverable amount after an impairment procedure. This is consistent with the corresponding US standard[7].

Regarding employee retirement benefit expenses and research and development expenses, accounting standards were established in 1998 that are similar to US GAAP. Although the inclusion of a cash flow statement as one of the necessary consolidated financial statements and the establishment of accounting standards for consolidated interim financial statements occurred in 1998 during the accounting Big Bang, the most notable development was the establishment of the Accounting Standards for Business Combinations in 2003. Until then, Japan did not have a systematic method of handling business combinations, which instead were addressed using an obscure method based on CC provisions rather than on the purchase method or the pooling of interests method. Under the CC, the merger or acquisition amounted to an investment in kind, so that in conceptual terms, the acquiring company would assume the net assets of the acquired company, which would be measured based on fair values. In practice, however, valuation based on less-than-market value was allowed, and it was common practice to revaluate the assumed assets upwards to offset the losses carried forward by the acquired company; any surplus went unrecognized and was treated as a latent capital gain[8].

By the time the Business Accounting Council had deliberated on the public draft for the Accounting Standards for Business Combinations, the US Financial Accounting Standards Board (FASB) had already abolished the pooling of interests method, and the International Accounting Standards Board (IASB) had released draft standards that were in line with the FASB stance. In Japan, however, the dominant opinion was that as long as there were

[7] Meanwhile, fair value measurement and profit recognition for investment property, which were debated alongside accounting standards related to asset impairment, were shelved on the grounds that the concept of “investment property” as defined under international accounting standards was too broad and therefore not useful in the Japanese context.

[8] Some have interpreted the CC as prohibiting acquisitions involving a loss carried forward due to their negative impact on capital maintenance. Another factor was that the acquiring company could not assume any loss carried forward under the tax law.

instances in which the acquiring company could not be identified (i.e., equal mergers), no matter how rare they might be, there should be a separate accounting process for them that would reflect their particular economic substances. Indeed, there were a number of mergers in which a company facing a financial crisis took advantage of the event to avoid delisting by recalculating the book value of the acquired assets upwards and using the surplus to offset its losses carried forward. Like the US, Japan did not permit going concerns to revaluate the book values of their business assets upwards. Partly to prevent the sorts of manipulative practices mentioned above, the finalized 2003 accounting standards for business combinations retained the pooling of interests method with strict constraints.

In the convergence phase (which will be discussed later), however, the pooling of interests method was singled out as a symbol of the foreignness of Japanese accounting standards and threatened to become an obstacle to a successful clearance of the assessment of equivalence by Europe. As a result, Japan abolished the pooling of interests method with its 2008 accounting standards and only permitted the use of the purchase method thereafter. Still, the purchase method is not only unusable for equal mergers, as pointed out above, but also somewhat arbitrary; it readily allows the acquiring company to become the acquired company, as long as the two companies are similar in size[9]. Now that the pooling of interests method has been abolished, there is no express rule that applies to such cases. Some advocate the fresh start method, but this particular method, despite having been debated for a long time, has many flaws and has never been incorporated into the US GAAP either. Using the fresh start method may lead to the upward revaluation of assets held at present whenever a going concern makes capital investment, which is equivalent to business combination in terms of the impact on a company's risk profile.

Regarding goodwill, which results from using the purchase method, both US standards and international standards prohibit systematic amortization and only permit the recognition of impairments. In contrast, the dominant opinion in Japan is that both amortization and impairment are necessary except in cases in which the value of goodwill was deemed to be permanent. Even when the value of goodwill appears to be maintained period after period, what is generally happening is that any exhausted goodwill is being replaced by new goodwill that is internally generated in each period as a result of business activities. Both tangible assets and goodwill acquired in a business combination are part of the cost of investment for the acquiring company. Therefore, just amortizing one of them seems inconsistent. Indeed, this policy may be a byproduct of a political compromise made during the establishment of the US standards[10]. The 2003 Japanese accounting standards provided for both systematic

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[9] It is not impossible for the acquired company to become the acquiring company in accounting terms if it issues shares and allocates a relatively small number of them to the shareholders of the other company, with the shortfall paid for with cash.

[10] See Watts (2006). Regarding the effect that the problems created by inadequate amortization of goodwill and its aftermath redressing, had on the formation process of modern accounting systems in the US, see Saito (1983).

amortization and impairment of goodwill. Although this rule may change during the convergence process, it is still under review at present.

4. Global Convergence: A New Challenge

In 2001, when the IASB was established under the banner of a global convergence of accounting standards, the Accounting Standards Board of Japan (ASBJ) was established as a private-sector organization, effectively taking over the role of a standards setter, which had previously rested with the Financial Services Agency (FSA). Although the direct reason for privatization was for Japan to increase its level of consistency with other major countries to facilitate Japan's participation in the IASB, a private-sector organization[11], there was another contributing factor. The postwar accounting standard reforms led by the FSA, which were aimed to help Japan catch up with the US, were more or less completed, paving the way for the creation of a rule-making regime run by market participants themselves. Nevertheless, as long as the ASBJ remains a private-sector organization, any standard set by it only becomes a social rule when authorization is given by the government sector with legal authority. Although the Japanese arrangement is similar to the US model, in which the SEC entrusts the development of standards to the FASB while retaining final authority (see ASR No. 150), Japan has adopted a system that requires the confirmation of each ASBJ decision via an announcement from the FSA.

The ASBJ, while pursuing an overhaul of Japanese GAAP, developed and revised accounting standards and set guidelines for their application in a vigorous effort to solve Japan's immediate problems and promote international convergence. Apart from those standards that addressed to issues requiring coordination with the CC, such as the disposal of treasury stock, reductions in the legal reserve, share-based payments, and the presentation of net assets, the accounting standards were established or revised in quick succession. These included standards regarding statement of changes in net assets, business divestitures, inventory measurement (requiring the use of the lower of cost or market value method and abolishing the Last-In First-Out method), financial instruments (expanding the disclosure of fair value information), related party disclosures, quarterly financial reporting, construction contracts (using the percentage of completion method only), and asset retirement obligations. This trend continues to this day. Regarding finance lease contracts, which have proven

[11] The concession that Japan was prepared to make to other countries in delegating standard-setting to a private entity is partly attributable to the move by overseas auditors to insert extra "legends" in their audit reports on Japanese companies' financial statements during this period. Those legends claimed that the statements were compliant with Japanese accounting standards but not necessarily based on international standards. Rather than clarifying the nature of the differences between the two sets of standards, they merely provided vaguely worded warnings that failed to specify the concrete differences needed for their removal. This issue called into question the wisdom of Japanese experts who took part in audits to support of those auditors.

difficult to coordinate with the tax system, the operating lease model that had been kept in place as an exceptional measure was abolished after six years of hard work.

These speedy developments were made possible through intensive deliberations within a robust review system based on full-time staffs, and never changed the standards setter's commitment on the importance of consensus building among market players. Although international convergence is an urgent task, a hasty top-down approach may not necessarily be the solution. Unlike in Europe, where the capital markets have been integrated, the market infrastructure varies widely from country to country in other parts of the world, and such an approach may actually delay convergence due to confusion during the implementation phase[12]. To decide on rules designed to regulate market transactions, including accounting standards, bottom-up processes such as market assessment and choice must be used. Whether the goal is to create domestic standards or achieve international integration, standards should be set through market processes in an incentive-compatible manner, rather than being handed down unilaterally by a standards setter[13].

In its efforts to facilitate convergence, the ASBJ envisaged a two-step strategy. The first step was to ensure that multiple sets of accounting standards, including Japanese accounting standards, could coexist in the capital markets by minimizing their differences. This would make it necessary to advance international coordination at least to a point at which Japan and Europe both accepted the International Financial Reporting Standards (IFRS) and the Japanese standards so that disclosers could freely choose to employ either set of standards without inconveniencing investors too much. If this led to competition among different sets of standards in the Japanese and European markets, it would further promote convergence by bringing about a sort of "natural selection" based on market processes in the form of investor assessment and choice. This would constitute the second step for convergence. In this step, the role of the standard setter would be to observe market assessments, use hypothetical bargains as necessary, and reflect the results in its standards. The 2004 "Medium-Term Operational Policy" statement expressed this vision[14].

Working from this perspective, the ASBJ launched a joint convergence project with the IASB in 2004. In 2005, they began meeting roughly every six months in Tokyo and in London to review each other's standards, including the conceptual framework. Initially, the two boards tackled easier issues to get the project on track quickly, and Japan more or less achieved all of its agreed-upon targets within about a year. In the next phase, which began in 2006, a comprehensive review was undertaken that was intended to identify all of the differences between the IFRS and the Japanese GAAP, sorting them into long- and short-term

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[12] See Ball (2006), Hail, et al. (2009), and other related studies.

[13] See Sunder (2002) and other related studies.

[14] Although this vision was expressed less aggressively in the 2007 version of the Medium-term Operational Policy statement, there was no difference in its emphasis on market assessment and choice (consensus).

categories and addressing them simultaneously in order of priority. Long- and short-term issues were classified as such based on the Memorandum of Understanding between the IASB and the FASB (February 2006), and Japan was required to commit to its long-term projects as soon as possible after quickly addressing its short-term issues. Japan, however, found itself also having to spend time on short-term issues to address the equivalence assessment being conducted by the European Union (EU).

As is well-known, in 2009, the EU planned to make it compulsory for companies from outside the region seeking equity-related financing to provide consolidated financial statements based on the IFRS or equivalent accounting standards, and the Committee of European Securities Regulators (CESR), a subordinate body of the EU, was working to assess the equivalence of domestic standards of countries which had no plans to adopt IFRS by that time. In July 2005, a recommendation affirming the equivalence of the accounting standards of the US, Japan and Canada with the IFRS was issued, but this was subject to remedial disclosures as to whatever differences their standards have from IFRS, with 26 differences identified for Japan. Some of those 26 differences, except 16 differences that were common with the US, were classified as short-term issues. Given that the relationship between accounting standards and associated legal or regulatory systems in Japan was different from the West, Japan needed to investigate those issues in detail as well[15].

For Japan, the equivalence assessment was a top-priority hurdle to clear. In January 2006, the ASBJ released a document called A Convergence Plan in Reference to Technical Advice on Equivalence by CESR and began tackling the task along the lines of this urgent action plan. In addition to the joint project with the IASB, the ASBJ, as part of its efforts to contribute to international convergence while developing domestic accounting standards, began holding semi-annual regular consultations with the US FASB in 2006 to jointly develop high-quality accounting standards. Utilizing the Japan-China-Korea Accounting Standards Setters Meeting forum, which had been in existence since 2002, joint efforts were also made with China and Korea to explore the potential for cooperation in the East Asian region and share one another’s experience in pursuing convergence through a different path.

In August 2007, the IASB and the ASBJ, which had by then met five times over two and a half years, signed a new agreement intended to accelerate the ongoing convergence efforts by setting deadlines (i.e., the Tokyo Agreement). The agreement required that, of all the important differences that existed between Japanese GAAP and the IFRS, those pointed out by the CESR in July 2005 as part of its assessment be dissolved by 2008 (more precisely, to

[15] Among the short-terms issues, excluding those issues that the US and Japan had in common, asset retirement obligations, the percentage of completion method for construction contracts, fair value disclosure for financial instruments, employee retirement benefits (discount rates), business combinations (the pooling of interests method), and the like were still unresolved at that time. Meanwhile, the CESR did not identify Japan’s call for the systematic amortization of goodwill in the context of business combinations as a major difference.

reach a conclusion that eliminates these differences or provides compatible accounting standards for those items), with the rest also to be dissolved by June 30, 2011. Although the agreement excluded IFRSs that were still under development and due for introduction in or after 2011, it was agreed that the two boards would closely work together to ensure that they would be acceptable to Japan by the time they were introduced. Importantly, both boards confirmed the fundamental principle of following their respective due process requirements in achieving those objectives.

Consequently, the ASBJ released a document called A Project Plan based on the Tokyo Agreement in December 2007 and revised it in September 2008 to further accelerate its convergence efforts. The pooling of interests method, which had long been singled out as a symbol of the differences between Japan's standards and the international ones, was abolished as stated above in the Accounting Standards for Business Combinations, issued in December 2008, and this completed the aforementioned ASBJ's short-term project. At that point, the EU concluded that it was appropriate to consider Japanese accounting standards as equivalent with the IFRS. In drawing this conclusion, the EU noted the existence of the Tokyo Agreement as well as the fact that the Japanese authority (FSA) was not demanding numerical adjustments to European companies' financial statements prepared in accordance with the IFRS. This ensured that Japanese accounting standards, like those of the US, would continue to be accepted in the European markets in 2009 and beyond.

5. Supplementary Remarks: Conceptual Framework

In concluding this paper, some supplementary remarks are made on the conceptual framework governing Japanese accounting standards. In Japan, the aforementioned "Business Accounting Principles" have long been the only comprehensive relevant conceptual document, and an implicit conceptual framework has been formed around them for all parties, including the government authorities, to share. The ASBJ, however, launched a project designed to develop a written conceptual framework in early 2003 and released a related discussion paper in autumn 2004. After being scrutinized for its effectiveness as part of the standard-setting process and repeatedly deliberated on during regular consultations with the IASB, the discussion paper was revised and released at the end of 2006. The reason why it was not released as an exposure draft to be finalized was the concern that, at a time when the IASB and the FASB were jointly deliberating on a new conceptual framework, any expression of differing views might have a negative impact on European equivalence assessment.

In accordance with the structure of the FASB's, this discussion paper consisted of four chapters: the objectives of financial reporting, qualitative characteristics of accounting information, elements of financial statements, and recognition and measurement in financial statements. While taking the asset-liability view, which regarded changes in assets and liabilities as a necessary condition for the recognition of income, it did not consider those changes as a sufficient condition, and kept net income alongside the comprehensive income[16]. It defined net income as the portion of the change in net assets that had been released from the risks of investment. Alternatively, the portion can be viewed as an uncertain outcome as expected at the time of investment turning into a confirmed fact (e.g., cash flow). An outcome released from risk is the realized change in market value in the case of investments made expecting capital gains without being constrained by business operations (i.e., financial investments), and the realized net cash flows in the case of investments made in pursuit of the results from business operations (i.e., business investments). Any elements of comprehensive income that do not meet these criteria are excluded from net income, and are reclassified into net income when they satisfy those criteria.

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[16] In other words, it is true that there is no income if there are no changes in assets and/or liabilities, but such changes do not necessarily equal income. This reflects the wide recognition of the informational value of net income that is derived from comprehensive income subject to certain additional conditions.

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