

Interim Report by Study Group on Corporate Accounting

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**Study Group on Corporate Accounting
Ministry of Economy, Trade and Industry**

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Introduction

Corporate Accounting is an important infrastructure element of capital markets, and has uniquely developed over a number of years, linked closely with various systems and practices in capital markets of individual countries. Corporate accounting in Japan has also developed to meet the broad demand from stakeholders surrounding enterprises, such as investors, under the Triangular System forming an organic corporate accounting system, in which three laws on accounting, the Securities Exchange Law, Commercial Code, and Corporate Income Tax Law, are mutually connected. Corporate accounting has played an important role in encouraging corporate executives to evaluate their own business activities, and it contributes to appropriate corporate behavior and business decisions. Furthermore, it has required corporate executives to prepare accounting information that reflects actual business conditions, and disclose information to stakeholders, including shareholders and investors, in the economic system. This study focuses particularly on corporate accounting as economic infrastructure. In this context, corporate executives are defined as the providers of accounting data, while stakeholders such as shareholders and investors are considered users.

As noted above, while Corporate Accounting has developed in close linkage with the economic systems of individual countries, corporate activities are not limited to single countries, but are increasingly globalized. As a result, capital procurement is also conducted in countries outside the “home” country. Capital markets themselves have reached the stage of encouraging capital inflow from foreign countries, instead of relying only on home country funding. Therefore, from the viewpoint of fostering international investment exchange and stimulating global markets, based on the securing of stability and confidence of capital markets, corporate accounting as a market infrastructure has become increasingly important.

Especially in European markets, listed companies within the EU are required to disclose consolidated financial statements in accordance with International Accounting Standards (IAS/IFRS) from 2005. Moreover, in the case of public offering and listing in the EU markets, corporations based outside the EU, including Japanese corporations, are also required to disclose their financial statements in accordance with “either EU-endorsed IAS/IFRS or third country GAAP equivalent to EU-endorsed IAS/IFRS” from 2007. Presently, the convergence of accounting standards are being addressed respectively between the International Accounting Standards Board (hereinafter referred to as “IASB”) and the Financial Accounting Standards Board (hereinafter referred to as “FASB”), as well as between IASB and the Accounting Standards Board of Japan (hereinafter referred to as “ASBJ”).

In the same way, as part of the advance of international convergence, it is essential for Japan to express our opinions, and to reflect on the revision and establishment of international accounting standards. In this context, this Study Group was established in October 2004, with the goal of organizing fundamental concepts for an ideal model of corporate accounting for the Japanese economy, centered on Japanese industries. The Study Group enjoyed participation by accounting experts, business leaders, scholars, and market players, as well as members of ASBJ and IASB as observers, and it conducted a broad-based examination of issues, including the organization and evaluation of a series of accounting “Big Bangs,” accounting systems of the Securities Exchange Law, the Commercial Code and Tax Law, and a survey of European accounting systems (for a total of eight meetings and fifteen working group meetings).

As a result of examination, the Study Group considers that accounting information reflecting corporate executives' views (basically to earn profits through continuous business) is important for ideal corporate accounting. Also, the perspective of an internationally equal footing¹ is considered to be critical in the increasingly globalizing economy, because corporate accounting is part of market infrastructure.

An especially important conclusion is that for accounting information to express actual business conditions appropriately it should reflect sustainable growth in corporate value through continuous business activities and global business development, at which corporate executives are aiming, and be useful for estimating future cash flows, and that net income is the most critical index to evaluate corporate value for stakeholders.

However, mainly in IASB, there is a tendency to disallow net income, extremely important information for us, and the examination is conducted in a direction that differs from our opinions. Consequently, it is essential to assert our opinions as mentioned above, and to reflect them in the revision and establishment of international accounting standards.

This interim report was organized to internationally convey the basic concept of the ideal corporate accounting approach for the Japanese economy.

1. Purpose and Aim of this Examination

While the revision and establishment of international accounting standards is advancing, it is necessary to have our opinions reflected in the process. From such a viewpoint, the purpose of this examination is to formulate and consider a basic concept of corporate accounting which is internationally universal and ideal for the Japanese economy, on the basis of actual business conditions in Japan, and to communicate that concept globally to reflect it in the revision and establishment of international accounting standards. In this regard, the views outlined below are considered important.

First, corporate accounting has the role of making corporate executives measure their own business activities, and leads to appropriate corporate behaviors and business decisions. It is also necessary for corporate executives to be responsible for producing financial statements to express the financial conditions and business performance of their corporations, and to disclose them to investors appropriately. For this reason, the establishment of accounting standards based on actual business conditions in Japan is needed. Furthermore, to support international corporate activities, our corporate accounting established on the basis of such a concept should be kept universal (or understood globally) to be accepted internationally.

Secondly, corporate accounting has the functions of supporting the decision-making of shareholders and investors, and the adjustment of related parties. The former is the function of presenting information on financial conditions and business performance of companies to stakeholders (information users, such as shareholders and investors), as material for their

¹ Equal Footing in this report means the view that the maintenance of market infrastructures is necessary to avoid disadvantages in competitiveness due to substantial changes in loss and gain caused by differences in accounting standards (market infrastructure), when Japanese corporations conduct business activities internationally.

However, this does not mean simply adjusting our accounting standards to US or international accounting standards. It is important to have adequate discussion and make progress with convergence, with a logical and practical background that can be explained and understood internationally to express the actual economic situation appropriately.

decision-making. This function includes information availability not only for shareholders and investors, but also for a broad range of other stakeholders including creditors, employees, and tax authorities. This provides material to resolve conflicts between stakeholders' interests in companies. In the examination of corporate accounting, it is considered important to take these viewpoints into account.

We formulated a basic concept which is ideal for the Japanese economy on the basis of the above-mentioned viewpoints and the following factors: the accounting Big Bang in Japan, accounting systems of the Securities Exchange Law, Commercial Code and Corporate Income Tax Law, the Discussion Paper "The Conceptual Frameworks of Financial Reporting" released by ASBJ last year (by the Basic Concept Working Group, updated in July and September 2004: hereinafter referred to as "Discussion Paper") in Japan, as well as the recognition of the current situation including international trends and ideas such as accounting systems and concepts in Europe and the U.S., convergence promoted with IASB (Convergence Projects between IASB and FASB, and between IASB and ASBJ), and assessment of the equivalence (equivalence between accounting standards in Japan, the U.S., and Canada, and international accounting standards).

Furthermore, based on the basic concept, individual issues considered important in advancing the revision and establishment of international accounting standards were examined. These included business reports (net and comprehensive income), the basic concept of consolidation, the recognition of income, stock option accounting, retroactive revision for previous years, special-purpose entities, accounting for business combinations, and lease accounting.

It is essential to reflect our opinions in the revision and establishment of international accounting standards, on the basis of results from those examinations. It is also important to fully explain actual corporate management in Japan and the basic concept of providing accounting information to stakeholders in Japan, in relation to ideas on the excessively biased evaluation system for the fair value of assets, and financial statements in which equity and income attributed to shareholders of a parent company are not indicated independently, which have been discussed in IASB.

2. Basic Concept

(1) Actual Corporate Management and Internationally Equal Footing

1) Actual corporate management and accounting information

As noted in "1. Purpose and Aim of this Examination", stakeholders in corporations such as investors and shareholders use disclosed information for various purposes, for example, making investment decisions, evaluating the stewardship responsibility of corporate executives, deciding and estimating credits, and evaluating employment stability.

Meanwhile, corporate executives operate companies that aim at continuous growth in corporate value, and act to earn income through business activities generating continuous growth. To respond to changes in corporate environments, such as technological innovation and more fierce competition, individual businesses are replaced, in the process of selection and concentration of business resources from a long-term perspective. However, the sale of a corporation or entire business in that

case is not judged as a result of corporate management aiming mainly at gaining speculative profits.

In this way, the actual corporate management aimed at by corporate executives should correspond to accounting information disclosed to stakeholders in a company, but not be substantially out of touch. This is because investors and shareholders also seek improvement in corporate value based on continuous growth in a company, and it is considered reasonable to disclose such information based on actual corporate management. Consequently, it is considered that accounting information should reflect the outcome of actual corporate activity aiming at continuous growth as much as possible.

Such disclosure improves availability of accounting information for investors and others, increases the value of individual corporations through a decrease in capital costs in fund-raising markets, and finally contributes to the growth and development of the entire economy and industry. Securing transparency of information, such accounting information is considered to be used effectively also as material for decision making by companies, stakeholders including creditors, employees, and business clients.

2) International equal footing perspective

Meanwhile, along with the advance of the global economy, competition between corporations has become global, and it is desirable to organize a market in which fair international competition is possible. For this purpose, it is necessary to deal with the convergence² of accounting standards and the infrastructure of markets, as well as secure the equivalency³ of accounting standards, as stated below.

The current joint project was set up by IASB (playing the main role), FASB, and ASBJ to consider the convergence of accounting. The EU already decided to adopt international accounting standards for consolidated financial statements of listed corporations. Along with their adoption, the European Commission directed the Committee of European Securities Regulators (CESR)⁴ to give technical advice on assessment of the equivalence of Japanese, U.S., and Canadian standards. “Technical Advice on Equivalence of Certain Third Country GAAP” was announced in July 2005, and Japanese accounting standards were recognized to be equivalent to the international accounting standards as a whole.⁵ (See Appendix 2

² Convergence means activity aimed at developing a single set of high-quality accounting standards, approximating accounting standards uniquely developed by each country, and internationally integrating them.

³ “Being equivalent” means that, even if investors and others use financial statements prepared with accounting standards other than International Accounting Standards, they can make decisions on investment on equal terms to using financial statements prepared with International Accounting Standards. In other words, if each item of standards necessary for investors is clearly defined in the applicable form, and at an equivalent level from the viewpoint of comparability, those accounting standards are considered equivalent, even if there are some differences in each set of accounting standards.

⁴ CESR (Committee of European Securities Regulators) is an organization established by the Commission of European Communities in June 2001, consists of securities regulation authorities of EU countries, and mainly plays a role in coordinating matters between securities regulation authorities of European countries.

⁵ Although Japanese accounting standards were evaluated to be equivalent to International Accounting Standards as a whole, supplementary measures are required for some items. Items requiring the disclosure of pro-forma financial statements on the basis of provisional calculation with supplementary statements include differences in the scope of consolidation of a special purpose entity, and differences in the pooling of interest

“Current Status of Convergence and the Assessment of Equivalence”)

Under such conditions, it is also important to put Japan on an internationally equal footing, aiming at ideal accounting standards for the Japanese economy. In that case, it is necessary to reflect our opinions fully in the revision and establishment of international accounting standards, approximating our accounting standards and international ones, if necessary.

The basic concept of corporate accounting based on actual corporate management in Japan, which was examined by the Study Group, is considered to secure availability of accounting information for corporate executives and stakeholders. It is necessary to actively communicate this concept for international convergence and assessment of equivalence.

(2) Reflection of Outcomes of Actual Corporate Activity and Net Income

1) Disclosure of corporate performance and net income

Companies act to earn profits through business activities generating continuous growth, and their performance and results are expressed with an indicator useful to estimate future cash flow gained by developing business continuously. For that indicator, the release from risks of income⁶ as a result of corporate business activities is considered important.

In other words, it is recognized that the results of business activities are released from risks at the point when, after being converted into commodities and other forms and becoming unavailable for other business, funds invested in the business become available to be readily invested in another business by collecting those commodities, etc. as cash and cash equivalents through external trading. The purpose of business activities is to generate and collect as much money as possible by investing funds in business to expose the venture to risks. Therefore, it is considered that the results of business activities are achieved at the point when cash and cash equivalents can be collected through external trading. In this way, the concept of “release from risks”, in which losses and gains are not recognized until business activities are achieved, has been the basis of Japanese and international corporate accounting, connecting with the concept in which non-money assets such as fixed assets are evaluated on the basis of acquisition costs.

method and the integration of accounting standards of overseas subsidiaries in business combinations. See “Appendix 2: Current Status of Convergence and the Assessment of Equivalence” for details.

⁶ In the “ Discussion Paper ” the expression “freedom from risks” is used, meaning that net profit is the result of investment free from risks (“ Discussion Paper ” : Recognition and measurement in financial statements p.59). In these materials, it is considered that business investment becomes free from risks, when assets that are not acquired risks are obtained, in other words, independent assets (cash) separated from the project of business investment are considered to be obtained (“ Discussion Paper ” : Recognition and measurement in financial statements p.60). Profit is recognized considering invested money to be free from investment risks, at the point when invested money becomes able to obtain independent assets which are not acquired by risks of invested business, after investing money in a business with prior expectation to obtain profits, bearing risks. In this material, the traditional and general term “realization” is not used because it was considered that definition would become more difficult with various interpretations of the past. Moreover, it was taken into account that the word “realization” would be mistakenly interpreted.

Based on this “release from risks”, in other words, an evaluation can be expressed with acquisition costs, financial conditions and business performance, etc. reflecting actual business conditions. The indicator broadly used to estimate future cash flow to be the basis of evaluation of corporate value is considered “net income” based on “release from risks”. This was verified with many empirical accounting analyses.⁷ Although not discouraged from disclosing comprehensive income referred to later, net income is considered to be the most crucial indicator for financial accounting when evaluating corporate value. In the case of disclosing comprehensive income with net income, recycling is necessary, in which unrealized appraisal gains or losses recognized once as “other comprehensive income”⁸ are reclassified to net income when these become released from risks.

2) Comprehensive income and recycling

In addition to disclosure of net income, there is a trend to disclose comprehensive income added to specific unrealized appraisal losses or gains. Even now, it is required to disclose not only net income, but also comprehensive income in the U.S. Initially, specific unrealized appraisal losses or gains recognized with systematization of current prices of financial instruments were directly included in capital in the U.S.⁹ However, as their existence became too substantial to ignore, the systematization of comprehensive income became more controversial.¹⁰ This disclosure of comprehensive income was introduced, aiming to eliminate the gap caused by changes in net assets on a balance sheet, and improve information transparency. For those purposes, it was necessary to disclose items which had been directly included in capital as “Other comprehensive income”, maintaining the concept of net income while conducting Recycling.

Meanwhile, in 1998, the special report “Reporting Financial Performance: Current Developments and Future Directions” (hereinafter referred to as “Reporting Financial Performance” was announced by G4+1,¹¹ and the disclosure of performance reports in which comprehensive income is the bottom line in place of traditional income statements was suggested. In Reporting Financial Performance, since the concept of “release from risks” is not regarded as so important, losses and gains “not released from risks” are not separated, and the recycling and disclosure of net income are not implemented. This idea was taken up as a performance

⁷ In “Profit concept and information value (2)” and “Basic concept of accounting standards” (Takashi Ohigata, Chuo Keizai Publishing Co., 2002), an experimental study on usability of information value of past net income and comprehensive income was examined. As a result, it was reported that the information value of comprehensive income is not recognized as higher than that of net income. In a part of “Other comprehensive income”, it is pointed out that there is some usability of information, but adequate proof is not accumulated.

⁸ “Other comprehensive income” means specific unrealized appraisal profit or loss, such as unrealized profit and loss held caused by currency translation adjustments and securities available for sale.

⁹ With “Reporting Comprehensive Income” in “Statements of Financial Accounting Standards (SFAS) No. 130”, reporting on comprehensive income is regulated. Comprehensive income is defined as “the fluctuation in corporate equity during a certain period caused by transactions from economic resources of an entity other than investors, other phenomena and environmental factors” (SFAC No.6, p. 70). In addition to net income, unrealized appraisal loss and profit is included.

¹⁰ The Association for Investment Management and Research (AIMR) organized mainly by securities analysts indicated concerns about an increase in items to enter directly into capital, and asserted the introduction of comprehensive income. (See SFAS No.130, p. 40, 41)

¹¹ G4+1 is a group consisting of accounting standards setting entities in Australia, Canada, New Zealand, the U.K., and the U.S., as well as IASC (International Accounting Standards Committee, a predecessor of IASB).

reporting project by IASB, and has been considered since 2001, but an agreement has not been reached yet.¹²

According to the above-mentioned idea, it is considered to be impossible to express appropriate business performance without accounting data on net income, which is useful to estimate future cash flows and based on “release from risks”. Consequently, it is not intended to discourage from reporting comprehensive income, but considered essential to disclose net income, and introduce the mechanism of recycling for that, even with comprehensive income reported.¹³

3) Disclosure of net income in consolidated financial statements

As for the preparation of consolidated financial statements, there are two concepts, a parent company and an economic unit. Under either concept, all assets and liabilities, as well as income and expenses of the corporate group under a single command, are presented in consolidated financial statements.

However, under the concept of the parent company, on the equity section of the consolidated financial statements the figure in which the equity of the parent company itself is added to equity held by the parent company in the equity section of subsidiaries is reflected. Consequently, equity held by shareholders of the parent company only is reflected. Finally, income attributed to shareholders of the parent company is reflected in net income.

Meanwhile, under the concept of the economic unit, all equity including equity held by minority shareholders of subsidiaries, as well as equity of the parent company itself, is reflected. As a result, equity held by all companies constituting the corporate group is reflected on the equity section of the consolidated financial statements. Accordingly, income attributed to minority shareholders of subsidiaries, in addition to that of the parent company, is reflected in net income. Although the concept of a parent company was currently generally accepted internationally, the accounting treatment consistent with the concept of an economic unit was adopted in International Accounting Standards (IAS) No. 27 revised in 2003 by IASB.¹⁴

According to the above-mentioned concept, in corporate groups the corporate executives of a parent company mainly aims at continuous growth in the company, and shareholders and investors in a parent company expect continuous improvement in such corporate value. Therefore, information presented in consolidated financial statements should be targeted to shareholders of a parent company. Consequently, net income should be reported as a fluctuating part of capital¹⁵ attributed to

¹² This has been continuously considered since 2004 as a joint project of IASB and FASB.

¹³ For details of the concept of net income and recycling, and its importance, see “3. Individual Issue (1) Business reporting (net and comprehensive income)”.

¹⁴ As the reason for this, the fact that equity of minority shareholders does not fulfill the definition of liabilities in “Framework for the Preparation and Presentation of Financial Statements” published by IASB is indicated. Since equity of minority shareholders is not a liability, losses and gains attributed to minority shareholders are not costs. Consequently, net income includes a partial attributing to equity of minority shareholders. FASB also published in June 2005 the public draft to regulate the indication of equity of minority shareholders in capital, “Consolidated Financial Statements, Including Accounting and Reporting of Non-controlling Interests in Subsidiaries - a replacement of ARB No.51”.

¹⁵ Capital attributed to the parent company stated here is the figure calculated by subtracting unrealized (not be

shareholders of a parent company (excluding direct dealing with shareholders).¹⁶

4) Net income and evaluation of fair value

As stated, from the viewpoint that net income as an indicator useful to foresee future cash flows is based on “release from risks” and unrealized appraisal losses or gains are not posted, it is totally opposite to the concept of evaluating non-money assets with costs at acquisition.

On the other hand, regarding financial instruments, there is a trend to include fluctuating differences of financial instruments in the calculation of net income, focusing only on changes in their fair value. This is insisted on as “full fair value accounting”¹⁷ to evaluate all financial instruments with fair value, regardless of purposes of holding by corporate executives.

Evaluating all financial instruments on fair value with a certain premise, abandoning the idea to disclose net income useful to estimate future cash flows on the basis of “release from risks”, and focusing only on a change in fair value of assets as noted above is considered to conflict with the Japanese concept. Of course, financial instruments for trading are evaluated focusing on a change in fair value of assets, even under Japanese accounting standards for financial instruments. When there is a market to trade securities intended to earn profits from trading, it is possible to earn profits anytime. Therefore, evaluation of fair value is considered to agree with the concept of “release from risks”, and not contradict the above-mentioned idea.

5) Evaluation of Accounting Big Bang

Corporate accounting in Japan has been rapidly developing with the Accounting Big Bang occurring as part of the reform of financial systems since the second half of the 1990's, and has reached a level comparable to international accounting standards such as the International Accounting Standards and U.S. Accounting Standards.¹⁸ In the reform of corporate accounting due to the series of measures

released from investment risks) “other comprehensive income” from Capital in existing consolidated financial statements.

¹⁶ For details of the basic concept of consolidation and its background, see “3. Individual Issues (2) Basic concept of consolidation”.

¹⁷ “Full fair value accounting” is stressed in “Financial Instruments and Similar Items” (Joint Working Group, 2000). The Joint Working Group consisted of accounting standards setting entities and associations of professional accountants (The Japanese Institute of Certified Public Accountants from Japan) from 9 countries, and the International Accounting Standards Committee.

¹⁸ Ministry of Economy, Trade and Industry “Interim Report by the Study Group on the Internationalization of Business Accounting” (June 2004, by the Study Group on the Internationalization of Business Accounting, Chairman; Kazuo Hiramatsu, President, Kwansai Gakuin University: Opinions on this report were collected in the business accounting committee of METI consisting of CFOs of major Japanese companies.)

In this report, Japanese accounting standards, U.S. Accounting Standards, and International Accounting Standards were compared technically. Finally, the conclusion that Japanese accounting standards are equivalent to others was conveyed to Europe, based on opinions mainly from concerned parties in Japanese industries and markets, as well as U.S. and European investors, and from the viewpoint that Japanese, U.S. and European investors can make similar decisions on investment.

In the draft on the assessment of the equivalence by CESR in Europe, Japanese standards were recognized as equivalent in general. However, remedies were required for some individual standards, for example, the scope of consolidation of special purpose entities, and the application of pooling of interest method and the integration of

comprising the Accounting Big Bang, new accounting standards were revised and improved drastically, referring to accounting standards in Europe and the U.S., in the wake of bankruptcies of major companies and distrust of capital markets in Japan. At that time, objective measurement became required as the range requiring elements of estimation, which had not been used before, was expanded and its importance increased.

Such an Accounting Big Bang can be considered to be a reform based fully on the above-mentioned concept developed by Japan. Simultaneously, it aimed at an internationally comparable level in consideration of disclosure to investors and shareholders, and its significance can be highly appreciated from the viewpoint of information availability for various stakeholders and international equal footing.

The introduction of an Accounting Big Bang like this can be considered effective to facilitate corporate actions to enhance business structure, in a period when the Japanese economy was stagnant as a whole. This reform was conducted to express the actual business condition in Japan appropriately, in the midst of changes in business activities, in which corporate executives began to make business decisions on a consolidated group basis to pursue efficiency, and changes in the business environment, such as the fall in land and stock prices. It is also appreciated due to its contribution to improvement in financial structure, promoting more active responses of companies, and provision of effective information to a broad range of stakeholders (See Appendix 1 “Evaluation and Assessment of Japan’s Accounting Big Bang”). Needless to say, continuous revision and improvement of accounting standards are required to respond to changes in actual corporate management. However, adequate consideration is necessary in order not to mislead stakeholders’ judgement due to larger scope of estimation and more difficult calculation of objective numeric values.

(3) Concept of Systematic Accounting including Commercial Code and Tax Law, and Their Convergence

1) Facilitating adjustment of interests of stakeholders

Net income based on “release from risks” can be considered rational not only as accounting information to estimate future cash flows and evaluate corporate values on the basis of this, but also for adjusting interests among a broad range of stakeholders in companies, such as employees, creditors, shareholders, and tax authorities.

In the dividend regulation to protect creditors in the Commercial Code, the dividend limit is decided on the basis of accounting numerical values calculated with corporate accounting considered as fair accounting practices. Also, the principle of definite settlement of accounts is adopted in calculation of taxable income, in which taxable income is calculated for tax purposes on the basis of accounting income settled with procedures in the Commercial Code, such as approval in general shareholders’ meetings.

In this way, in Japan, the corporate accounting system has traditionally played important roles in adjusting interests among stakeholders in companies, including the relationship with the Commercial Code and tax law. In the same way, corporate accounting systems are structured to play roles in adjusting interests not only in Japan but also in European countries¹⁹ (See Appendix 3 “Outline of Corporate Accounting System in Japan, Germany, France, the UK, and the US”).

2) System of using Commercial Code financial statements affirmed at shareholders’ meetings

The system of using Commercial Code financial statements affirmed at shareholders’ meetings adopted in Japan agrees with not only requests from tax authorities, such as a decrease in monitoring costs for appropriate taxation, but also those from companies, such as lower administrative costs. It is inefficient to conduct calculations separately for tax accounting and commercial accounting. Therefore, it can be considered rational to use income calculated with commercial accounting for tax accounting as a starting point for calculating taxable income to decrease corporate costs.

Even if the gap is caused by changes in global trends in the corporate accounting system in accordance with legal purposes, it is reasonable to maintain a certain relationship, focusing on such benefits.

3) Deductible expense accounting requirements and calculation of profit base and issues related to the adverse effects on accounting of prioritizing taxation

In tax law, it is required to recognize certain items as expenses or losses in defined settlement. For example, although internal calculation of expenses, such as depreciation costs, should originally be decided by a company, the amount cannot be confirmed objectively, and there is concern that it is influenced strongly by corporate subjectivity. Therefore, a system has been adopted in which recognizing an amount as an expense in defined settlement is required, and tax authorities accept it within a certain range of limited amounts, on the basis of corporate decision making.

As for such deductible expense accounting requirements and calculation of profit base, problems relating to adverse effects are sometimes pointed out. This is because there is a concern that corporate accounting treatment is limited and appropriate treatment is distorted depending on the tax treatment the company chose, due to regulation of tax treatment based on defined treatment in Corporate Tax Law.

However, the regulation of depreciation costs and other factors in the taxation system indicates the limited amount able to be included in losses, and the tax system is basically considered to be regulated corresponding to actual business

¹⁹ German, French, and U.K. corporate accounting systems are based on the commercial code (the corporate law). Taxable income is calculated by adding the necessary adjustment for taxation to corporate income as a starting point. On the other hand, in the U.S., since there are not many regulations for accounting stipulated by the Corporate Law, accounting under the Securities Exchange Law is the base of the accounting system. Taxable income is calculated separately from corporate income.

conditions. Furthermore, a company cannot easily post losses because they should be recorded as expenses in corporate accounting in order to be included as losses in tax treatment. Therefore, deductible expense accounting requirements and calculation of profit base acts as a kind of monitoring of tax treatment, and is considered rational in the entire business system.

Consequently, from viewpoint of the total system including tax, deductible expense accounting requirements and the calculation of profit base and system of using Commercial Code financial statements affirmed at shareholder's meeting on which they are based can be appreciated as having economic rationality including stability as a system and a decrease in corporate burden.

4) Gap between corporate accounting and tax accounting

Since revision of the tax system in FY1998, corporate accounting and tax accounting have been losing touch with each other.²⁰ In concrete terms, while various kinds of allowances were eliminated in tax treatment, the accounting standards including elements of estimation were set up, which were unacceptable for tax logic such as accounting for impaired assets.

The tax system is regulated to achieve political purposes, including use of tax as an economic policy tool and securing of stable tax revenue. When it is regulated in the policy aspect, it is true that there are certain limitations to ensure that tax accounting, which is a basis of the tax system, conforms to corporate accounting aiming to reflect the outcome of actual corporate activity as accurately as possible.²¹ Therefore, it is expected that the relationship between the two will continue to be considered.

5) Consolidated accounting data and consolidated dividends

Due to the advance of globalization and diversification of corporate activities, corporate management itself is shifting to a group management basis, and consolidated data is becoming more effective as information for investment. When consolidated financial statements were first introduced, the disclosure of consolidated data under the Securities Exchange Law was just a document attached to the annual securities report. Now it focused on data on the corporate group including consolidated financial statements.

²⁰ In the revision of the taxation system in FY1998, various kinds of allowances were reduced, and the basis of taxation was expanded, accompanying the implementation of a decrease in the corporate tax ratio. This is based on the concept that it is appropriate to handle taxable earnings of corporate tax in a different way from accounting treatment based on various standards of the Commercial Code and corporate accounting, from the viewpoint of proper taxation. This revision can be said to be a trigger to the advance in deviations between corporate accounting and tax accounting in recent years.

In the revision of the taxation system in FY2001, the tax system for organization restructuring was introduced. Under this system, regardless of accounting treatment, the handling of taxation differs depending on whether or not it agrees to certain requirements decided by tax law. Consequently, when treatment in taxation is different from accounting treatment, an adjustment for taxable income should be conducted.

²¹ In such a case, tax adjustment is implemented and taxable income is calculated based on income in corporate accounting. In this respect, systems in European countries are similar. (See Appendix 3 "Outline of Corporate Accounting Systems in Japan, Germany, France, the U.K., and the U.S.")

In the Commercial Code, the consolidated financial document system was introduced in 2004, aiming at enhancing information on corporate groups, in consideration of the fact that corporate management for corporate groups is shifting to a consolidated group management basis. Furthermore, if consolidated accounting data is emphasized more in the data disclosed to investors and shareholders, there is the opinion that dividends, as returns from income to shareholders, should be linked with the consolidated data for disclosure. Actually, when corporate executives make business decisions, the optimal distribution of business resources on a consolidated basis is emphasized. Accordingly, through monitoring from markets, and outside audit,²² there is the opinion that payment of dividends on a consolidated basis should be accepted in companies governed well as a whole group.

On the other hand, the consolidated dividend system is presently accepted in the U.S., but not in European countries such as Germany, France, and the U.K. (See Appendix 3 “Outline of corporate accounting system in Japan, Germany, France, the U.K. and the U.S.”). In the U.S., where the consolidated dividend system is adopted, adjustment of interests is said to be conducted with contracts.²³ The legitimate dividend system is considered not to function in practice there, and cannot be easily compared to systems in which the dividend regulation in the Commercial Code functions well, as in Japan.

Under the existing Commercial Code, it is not acceptable to provide appraisal profits from financial instruments as a source of dividends.²⁴ Furthermore, there is the opinion that retained earnings of subsidiaries included in retaining earnings in consolidated financial statements should not be provided as a source of dividends as “released from risks” profit, unless a parent company sells subsidiaries.²⁵ Therefore, consolidated dividends are expected to be examined from the aspect of the legal system in the future.²⁶

6) Divergence and convergence

In the EU, although the adoption of international accounting standards will be imposed on listed companies for preparation of consolidated financial statements from 2005, adoption of parent-alone financial statements is up to the decision of

²² Including outside audit by auditors, and audit by an audit committee consisting of outside board members in the companies with such audit committees.

²³ In the U.S., since the statutory regulation on dividends is not strict, financial institutes, bond holders, and preference shareholders try to protect themselves, requiring material and personal guarantees, and setting various articles for financial limitation in securities of loan contracts, corporate bonds, and preference shares. (See “Capital system in U.S.” by Yasushi Ito; “Comparative study on corporate law (Seeking corporate law system in the 21st century: Study group on commercial legal services, 2003)” by Shigeru Morimoto)

²⁴ Under, Article 290, Clause 1 of the Commercial Code and Article 124 of the Commercial Code implementation regulation, the amount of net assets on balance sheets which increased by evaluating monetary claims at fair value is deducted in the calculation of limitation of profit sharing.

²⁵ This is the concept that since the body paying dividends is not the business group, but the parent company, earnings which cannot be said to be realized on financial statements of the parent company should not be a resource for dividends. This is the same concept that assumes property of subsidiaries cannot be reserve property for creditors of the parent company, under the existing stock company system based on the limited liability system.

²⁶ In the revision of the Commercial Code in 2002, whether the function of dividend regulation should be included in consolidated financial statements or not was controversial, but finally it was not included.

each country.²⁷ It is assumed this will cause divergence between many EU listed companies, even if only temporarily (See Appendix 5 “IAS/IFRS Implementation in 2005, Revision of Domestic Law, and Trends in Practice in the EU”). For the time being, in Germany, France, and the U.K. respectively, the reform of accounting systems is being sought in terms of adopting international accounting standards for parent-alone financial statements, based on each country’s systems including commercial code and tax law. (See Annex 6 “Activities for convergence and reform of accounting system in Germany, France, and the U.K.)

On the other hand, under the existing Securities Exchange Law in Japan, it is acceptable for companies submitting consolidated financial statements on the basis of U.S. accounting standards to the Securities and Exchange Commission (SEC) to submit such consolidated financial statements to the Financial Services Agency in Japan. Consequently, some divergence with parent-alone financial statements produced on the basis of Japanese accounting standards is generated.

The disclosure of consolidated financial statements aims to reflect the actual situation of globalized and diversified corporate activities as well as possible, and is based on the same concept as parent-alone financial statements, from the viewpoint of disclosing actual corporate management. Accordingly, consolidated financial statements are produced on the basis of parent-alone financial statements of subsidiaries belonging to the consolidated group. Therefore, it is necessary for the principle and procedures of accounting treatment which should be adopted for the accounting system in Japan to be made uniform in consolidated and parent-alone financial statements in principle.²⁸

If it becomes necessary to put priority on the convergence of accounting standards in consolidated financial statements focused on more by investors, it may be possible to allow divergence from parent-alone financial statements. Even in that case, careful consideration is necessary, and if divergence occurs, it should be temporary.

3. Individual Issues

Based on the above-mentioned basic concept, the Study Group organized such individual issues as performance reporting (net and comprehensive income), the basic concept of consolidation, the recognition of income, stock option accounting, the retroactive revision for previous years, special-purpose entities, accounting for business combinations, and lease accounting.

(1) Performance Reporting (net and comprehensive income)

In the project on performance reporting discussed in IASB, the construction of a performance reporting system has been considered, in which comprehensive income is

²⁷ Few countries enforce the application of International Accounting Standards to parent-alone financial statements due to the need to make adjustments for the commercial code and tax law of each country. Greece, Portugal, and Cyprus do so.

²⁸ There may be differences in accounting treatment based on differences in the scope of items recorded, such as how to handle affiliated companies, between consolidated financial statements and parent-alone financial statements.

regarded as the only indicator of business performance during the corporate fiscal period in corporate accounting. Comprehensive income is the indicator reported as a change in net assets (liabilities deducted from assets) in a balance sheet during a certain fiscal period, excluding direct transactions with shareholders.

In the performance reporting system in this project, the idea is suggested of abolishing the disclosure of business indicators other than comprehensive income, such as net income, and prohibiting recycling,²⁹ whereby “released from risk” losses and gains in comprehensive income are reclassified as net income even if net income is disclosed as a breakdown of comprehensive income.

We have no choice but to regard such ideas as limited suggestions, considering the purpose of accounting to express actual corporate management, as observed so far. Consequently, the promotion of this project by IASB and its introduction as a practical accounting system are incompatible with Japanese concepts.

In the IASB concept, assets and liabilities are defined first, and a change of net assets during a period, i.e. their balance, is regarded as business performance. Practically, concerning the concept that a company recognizes profits and expenses through business activities, and computes profits focusing on their relationship, in IASB it is problematic that unrealized losses and gains of assets, especially financial assets, can be “released from risks” at the discretion of corporate executives.

Meanwhile, the following concept is considered effective for reflecting the outcome of actual corporate activity.

The measurement of income in a period is conducted by computing income as a balance (of incomes and expenses), focusing on the matching of income and expenses that can be recognized and measured. Then, the computation of income is adjusted by increasing or decreasing the estimate of some assets and liabilities at the end of the period, in a complementary manner. Going through such a computation process, net income is regarded as an important indicator for estimating corporate value, for various stakeholders including investors.³⁰

As for the fact that the unrealized losses and gains from financial assets can be freely released from risks on the judgment of corporate executives, the judgment to realize release from risks itself is regarded as important information for various stakeholders such as investors. This is because cash flows gained with release from risks of unrealized losses and gains by corporate executives are intended to be invested in other assets, and may cause changes in cash flows generated later.

²⁹ “Recycling” means adding to net income the part released from risks in the current term, from comprehensive income which was not posted on net income in the past year. For example, when other securities are evaluated at fair value, the variance of the estimate is not recognized as income, and the amount posted on balance sheets is directly added or subtracted. At that time, variance of the estimate is reported in “Net unrealized gain (loss) on available-for-sale securities”. When income is “released from risks” by selling those securities in the current term, “Net unrealized gain (loss) on available-for-sale securities” requires another accounting process to be included in the calculation of net income.

³⁰ In the joint international group meetings and other meetings on business reporting conducted by IASB, similar opinions from European and U.S. industries have been expressed. For example, a survey found that 68% of institutional investors and analysts are against the abolishment of net income. (“Study Group on Internationalization of Business Accounting” Survey on industries and investors, March 2004)

In this way, net income is considered to present useful information for estimating future cash flows generated through developing business continuously. It is also highly effective as information for investors, because of its value as feedback for confirming the result of estimates of future cash flows after the fact. This point has been verified in a number of empirical studies.³¹

Furthermore, net income is considered suitable as an indicator to measure the business achievements of corporate executives and employees, underlying their capacity for tax-paying, and their margin for distributing income to shareholders (dividend payments).

Such concepts do not deny the disclosure of comprehensive income. The item called “other comprehensive income” is possibly valuable as information for stakeholders such as investors. It is also a fact that sharp falls in stock markets and fluctuations in exchange markets influence the increase or decrease of net assets.³²

As for the relationship between the items on a balance sheet and net income, among net assets in the consolidated balance sheet (figures deducting liabilities from assets), the figures which various stakeholders such as investors emphasize as valuable information are those attributed to shareholders of the parent company.³³ Therefore, in the Discussion Paper “The Conceptual Frameworks of Financial Reporting” in Japan, this figure attributed to shareholders of a parent company is named “Capital”, and regarded as a special item in “net assets”. Net income means the part excluding direct transactions with shareholders from the periodical balance of this “Capital”.

One reason why this net income attracts attention from various stakeholders such as investors as the result of corporate business performance is that its amount increases or decreases the part attributed to shareholders of a parent company (= “Capital”). The reason that an investor uses information on earnings per share (EPS) to broadly consider the appropriate level of corporate share prices (value per share) is that the “Capital” per share attributed to a parent company increases or decreases depending on that information.

(2) Basic Concept of Consolidation

In considering consolidated accounting, there are two theories, as follows:

- i) Concept of a parent company in which it is considered that consolidated financial statements should be prepared from the viewpoint of shareholders of the parent company

³¹ See Footnote No. 7

³² When comprehensive income is disclosed, disclosure of net income after recycling is essential.

³³ Capital, capital surplus reserve, retained earnings, and own shares (minus items) are considered to fall under the part attributed to shares of the parent company. This does not include parts attributed to any party other than the parent company, such as the equity of minority shareholders, or a part for which attribution is not decided, such as share warrants.

Even in “Other accumulated comprehensive income” typified by unrealized gain (loss) on available-for-sale securities and adjustment on foreign currency translation, the gain (loss) is not included in the part attributed to shareholders of the parent company due to the concept that the attribution is not decided until the gain (loss) is “released from risks”.

- ii) Concept of an economic unit in which it is considered that consolidated financial statements should be prepared for comprehension of the actual corporate activity from the viewpoint of the entire corporate group targeted for consolidated financial statements.

Depending on whether the main body of consolidated accounting is recognized to be the parent company or the entire corporate group, the definition of Owners' Equity is totally different, and the purpose of preparing consolidated financial statements and various accounting processes, such as accounting for business combinations, are fundamentally influenced. As a result, completely different financial statements are prepared.

In the concept of the parent company, since minority shareholders who are not shareholders of the parent company are not regarded as the main target for reporting, minority shareholders' equity is not included in Owners' Equity. For example, in the case of consolidating a subsidiary with an equity ratio of 60%, after consolidating on the basis of 100% of assets and liabilities, the 40% which is the balance of assets and liabilities is excluded as minority shareholders' interests. Then, minority shareholders' equity is posted as an item with an intermediate existence between liabilities and capital.

On the other hand, in the concept of the economic unit, since minority shareholders are also regarded as a target for reporting, minority shareholders' equity is included in Owners' Equity.³⁴

So far, the concept of the parent company has been dominant, and both U.S. and Japanese accounting standards were structured on the basis of this concept. However, IASB and FASB are moving to the direction of restructuring them, centering on the concept of the economic unit.³⁵

In the U.S., there existed the basic concept of consolidation that it is a fair procedure of consolidation in which the contents should be confirmed by breaking them down, after studying the consolidated financial statements of the entire group excluding the influence of the equity ratio of a parent company. This concept is based on the idea that minority shareholders' equity should be included in Owners' Equity in the light of the definition that items other than liabilities are posted in Owners' Equity on the conceptual framework, since they are not considered to be liabilities because of the lack of features defining liabilities such as the fact that no payment deadlines exist.

When changes in net assets at the beginning and the end of the period on the balance sheet based on market value are considered the business performance of the current period, the method of preparing financial statements consolidated on the basis of 100% (market value method in the procedure for consolidation, etc.) can maintain theoretical consistency better than when the financial statements are made by taking the equity ratio of a parent company into account. This seems to be the main reason that IASB and FASB have recently taken on the concept of the economic unit.³⁶

³⁴ The example of the case that retained earnings of the subsidiary with an equity ratio of 60% (50) is shown below:

Parent Company		Subsidiary (ratio of parent company's equity at 60%)		Consolidation																
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;">Fixed assets 104</td> <td style="padding: 5px;">Liabilities 60</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;">Investment</td> <td style="padding: 5px;">Capital</td> </tr> </table>	Fixed assets 104	Liabilities 60	Investment	Capital	+	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;">Fixed assets 100</td> <td style="padding: 5px;">Liabilities 40</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Capital 10</td> </tr> </table>	Fixed assets 100	Liabilities 40		Capital 10	=	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;">Fixed assets 204</td> <td style="padding: 5px;">Liabilities 100</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Equity of minority shareholders 24</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Capital 50</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Retained earnings 10</td> </tr> </table>	Fixed assets 204	Liabilities 100		Equity of minority shareholders 24		Capital 50		Retained earnings 10
Fixed assets 104	Liabilities 60																			
Investment	Capital																			
Fixed assets 100	Liabilities 40																			
	Capital 10																			
Fixed assets 204	Liabilities 100																			
	Equity of minority shareholders 24																			
	Capital 50																			
	Retained earnings 10																			

In the above case, among retained earnings 50 of the subsidiary, only 30 (50 x 60%) is included in retained earnings in consolidated financial statements. Twenty (50x40% (attributed to minority shareholders)) is indicated midway between Capital and Liabilities as the equity of minority shareholders, together with 4 (10 (capital of subsidiary) x40%).

Consequently, the total of Capital in consolidated financial statements is 80.

Meanwhile, in the same example, consolidated financial statements based on the concept of the economic unit are as follow:

Parent Company		Subsidiary (ratio of parent company's equity at 60%)		Consolidation																
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Liabilities 60</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;"></td> </tr> </table>		Liabilities 60			+	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Liabilities</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;"></td> </tr> </table>		Liabilities			=	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;">204</td> <td style="padding: 5px;">Liabilities 100</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Retained earnings 150</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Equity of minority shareholders 30</td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;"></td> <td style="padding: 5px;">Capital 24</td> </tr> </table>	204	Liabilities 100		Retained earnings 150		Equity of minority shareholders 30		Capital 24
	Liabilities 60																			
	Liabilities																			
204	Liabilities 100																			
	Retained earnings 150																			
	Equity of minority shareholders 30																			
	Capital 24																			

In this case, among retained earnings 50 of subsidiary, 20 (50 x 40% (attributing to minority shareholders)), equity of minority shareholders, is part of the Capital and the total Capital becomes 104.

³⁵ In June 2005, IASB and FASB respectively published public drafts to revise existing accounting standards to conduct accounting treatment based on the concept of the economic unit, "Amendment to IFRS No. 3" and "Business combinations: a replacement of SFAS No. 141". In both public drafts, the amount in excess of fair value of the entire acquired company to the net amount of identifiable acquired assets and acceptance liabilities of the acquired company is goodwill. The total goodwill method is adopted, in which goodwill attributed to the equity of minority shareholders is recognized.

³⁶ In procedures of consolidation, it is necessary to evaluate assets and liabilities of subsidiary at market value at obtaining control. The methods for this evaluation include the partial market value method and the total market value method. In the partial market value method, only the part acquired by the parent company is evaluated at market value, excluding the equity of minority shareholders. Since the equity of the parent company on obtaining shares is emphasized, this concept matches the concept of a parent company, but the concept of the economic unit. In the case of adopting this method, since a part of assets and liabilities is evaluated at market value, market value and acquisition costs are mixed in a single evaluation for assets and liabilities.

Meanwhile, in the total market value method, all including the equity of minority shareholders is evaluated at market value on acquiring control. This concept focuses on the fact that subsidiaries became included in the business group, as the result of the parent company's subsidiaries. Consequently, the concept of the economic unit matches only this method. In the case of adopting this method, since all assets and liabilities are evaluated at market value, the amount indicated in balance sheets is considered to be evaluated at market value on acquiring control.

As mentioned, IASB and FASB are shifting from the concept of the parent company to the one of the economic unit. However, in Japan, the main users of consolidated financial statements are the shareholders of a parent company. Actually, net income per share based on the net income of the parent company's equity is used for investment decisions. Therefore, the parent company's style should be followed. The main player to develop business continuously is corporate executives of the parent company, and interested parties are mainly shareholders of a parent company. From this viewpoint, it can be said that consolidated financial statements should be based on the theory of the parent company.

(3) Revenue Recognition

In the U.S., there are detailed rules on revenue recognition, and especially, they have been strictly applied in audits, since the enactment of SOX Act. Now in the U.S., among things pointed out in audits, many are problems related to revenue recognition.

Among a number of rules on revenue recognition standards in the U.S., the core is "Staff Accounting Bulletin (SAB) No. 104" announced by SEC. In this rule, revenue is recognized as "being realized or realizable" and "earned". According to "Statement of Financial Accounting Concept No. 5", at the time of completing delivery of money, and rendering services, revenue is recognized to "be released from risks or realizable". Also, at the time when activities conducted to enjoy benefits from income are virtually completed, this is considered "earned". SAB No. 104 is so strict that revenue is recognized to "be released from risks or realizable" and "earned", only when all requirements for delivery and decision of prices are fulfilled.³⁷

Meanwhile, in the U.S. standards, there are the EITF00-21 rules, "Accounting for Revenue Arrangements with Multiple Deliverables". This regulates the accounting treatment of dividing multiply separated transactions based on fair value, banning the recognition of revenue in a lump sum. In the U.S., although it is said that there are over 180 rules related to recognition of revenue, there is not any unified concept. Therefore, there may be cases that are difficult to handle.

If SAB No. 104 is strictly applied, there may be very difficult cases about judgement of completion of delivery or verification. Especially, in cases of complicated products requiring a lot of time for inspection, and returnable goods, it is difficult to recognize the time of completion of delivery, and various arguments occur at audit sites. Furthermore, as for transactions called Multiple Deliverables, such as transactions with maintenance contracts and after-sales service, custom-made orders to implement installment and training, transactions of mobile phones accompanying phone service, or sales of software with rights for free version upgrade in future, EITF00-21 is applied, and it is required to calculate their fair value by dividing those transactions.

³⁷ The fair requirements announced in Staff Accounting Bulletin: SAB No. 104 by SEC in U.S. are as followed:

1. Persuasive evidence of an arrangement (agreement) exists.
2. Delivery has occurred or services have been rendered.
3. The seller's price to the buyer is fixed or determinable.
4. Collectibility (payment) is reasonably assured.

As stated above, in the U.S., as economic transactions are getting more complicated, a number of rules related to recognition of revenue have been announced. To organize and unify these rules, and develop accounting standards with consistent and comprehensive recognition of revenue, FASB started a revenue recognition project in cooperation with IASB. In this revenue recognition project, “release from risks or realizable” and “earning”, indicated in “Statement of Financial Accounting Concept No. 5”, are abolished, and income is recognized and measured, focusing on “increase in assets” and “decrease in liabilities” instead. In this approach,³⁸ “increase in assets” and “decrease in liabilities” are measured with fair value or performance value.³⁹

However, such an approach, in which the concept of “release from risks” is abolished, and only “increase in assets” and “decrease in liabilities” are focused on, loses touch with business practices in which revenue is recognized at the point of delivering goods and providing services. Therefore, it cannot be necessarily said to reflect actual corporate management. Furthermore, the changes in approaches on recognition of revenue considered by IASB and FASB have much to do with the fundamental concept of what income is. Consequently, they are expected to influence practices such as everyday sales activities and accounting treatment.

Also in Japan, the review of standards on revenue recognition is being considered, referring to related existing U.S. standards, in the wake of the accounting frauds of some IT companies.

In this regard, we should respect the fact the operation has been conducted based on the actual business conditions, on the basis of the traditional concept of “release from risks”, focusing on the joint project of IASB and FASB, and disputes in the U.S., and fully comprehending the actual figures of new transactions typical in IT industries.

(4) Accounting for Stock Options

Since stock options were permitted in 1997 in Japan, over 1,200 companies have utilized this system. Although one of its features is often believed to be the advantageous issue of shares to executives and employees, some companies regard it as one of their treatment. Because of the prevalence of this system, ASBJ is presently addressing the development of accounting standards for stock options.

In developing accounting standards for stock options, the concept that the value of stock options recognized is processed as costs over a certain period is adopted, based on the idea of expressing the actual business conditions exactly as examined by the Study Group.

³⁸ Performance value means the amount for which goods and services can be sold to customers. For example, when the company receives advance payment liabilities, they are recognized and measured with the amount that should be returned to a customer, if the obligation of performance is not fulfilled. At the point of decreasing that liability, income is recognized as that amount.

³⁹ In the process of examination in the project on revenue recognition, revenue recognition on making a contract (selling revenue) has been examined. It was considered that the balance of that counter-value and the company's fair value of performance obligation (the price to pay for the similar contracts in the market) is recognized as revenue, when the counter-value is received as a sales deposit. Moreover, the fact that rights and obligation in contracts of transactions (product guarantee, exchangeable rights, and financial guarantee) are recognized and measured at fair value is being studied.

In summary, as a general rule, the value of stock options granted to executives and employees is calculated at fair value with measuring methods used internationally such as the Black & Scholes Model, using objective data understandable to investors, including the share price of that company and its volatility, and interest rates.

However, these measuring methods are not necessarily unified. As seen in cases of unlisted companies, when share prices and volatility cannot be measured, an alternative method to which many stakeholders such as shareholders can agree should be adopted.

As for the fair value recognized at the time of granting stock options, from the viewpoint of expressing the actual business conditions exactly, procedures to recognize costs are regularly required over the objective employment period of executives and employees granted stock options. The ground for decrease in income with this procedure is that a part of the capital to be attributed to existing shareholders could be transferred to executives and employees granted stock options (potential shareholders who have possibility of becoming new shareholders in future).

Whether or not such transfer of capital is implemented is finally decided by whether or not executives and employees granted stock options execute their option or not. In other words, when options are executed by executives and employees, the part executed is regarded to be attributed to them, the new shareholders. When not executed, it is considered that costs distributed for that part are returned, and income is recognized.⁴⁰

The recognition of costs for stock options is adopted not only in accounting standards scheduled to be introduced in Japan, but also in International Accounting Standards and U.S Accounting Standards, which have already been utilized. This concept of recognizing costs for stock options is based on the idea that income and costs are recognized and measured to calculate income as a difference (of income and costs), focusing on their matching.

(5) Retroactive Revision for Previous Years

One of the differences between Japanese accounting standards and International Accounting Standards and U.S. Accounting Standards, is the concept on retroactive revision for previous years. For example, in the International Accounting Standards, the following four cases are examples of revising financial figures of previous years retroactively.⁴¹

⁴⁰ For example, suppose that the value of stock options offered to employees and executives is 10,000. When their employment period is 5 years, it is necessary to recognize the annual cost of 2,000 over 5 years. In this part, capital attributed to existing shareholders would decrease due to a decrease in income. After that, when 70% of stock options are executed by employees and executives offered (they newly became shareholders), 7,000 is recognized as capital paid in by new shareholders. As for 30% of stock options which have not been executed yet, recognizing $10,000 \times 30\% = 3,000$, which was recognized as expenses, as income, the part recognized as expense in the past years can be adjusted.

There is an other concept of not adopting the method of separating accounting treatment, depending on whether the option is executed or not (in that case, all of the 1,000 recognized as expenses is considered to be paid-in capital.) However, so far, whether it is finally recognized as capital paid in by new shareholders, or as income attributed to existing shareholders would not be found until the presence or absence of execution is determined. Accordingly, methodology to separate accounting treatment in the light of the purpose of accounting, "measurement and disclosure of income", that reflects actual business conditions is considered logical.

⁴¹ The revision of measured value based on estimates in accounting and radical forecasts, due to later environmental changes is not considered revision in past years, and not subject to retroactive revision.

- a. When indication and classification this year were revised in comparison with the previous year, there is a regulation to revise retroactively the following sections this year.
- b. When the accounting policy is changed, each item from the beginning of the oldest period among disclosed periods is revised retroactively on the basis of treatment after a change in accounting policies.
- c. Critical errors that occurred in previous years are required to be revised retroactively.
- d. In indicating and disclosing losses and gains from discontinued operation, assets classified as scheduled to be sold is classified in a balance sheet, and comparative figures in previous years are revised retroactively, corresponding to the change in the indication this year, and then classified and indicated as a discontinued operation in an income statement.

Meanwhile, in Japanese accounting standards, as a general rule, retroactive revision does not occur.⁴² In the cases of a. and b., comparative figures in previous years are not revised retroactively, and the influenced amount in the indicated classification, reasons of changes, and the influenced amount due to a change in the accounting policy are indicated as notes. In the case of d., in principle, the extraordinary profit and loss item in income statements of a current period should be recognized without retroactive revision.

From the viewpoint of information utility for investors, there is the opinion that retroactive revision should be introduced. In other words, that the conducting of retroactive revision facilitates the comparison between business performance in a current period and one in previous years more easily.

However, due to the reasons below, we should be careful about introducing retroactive revision in principle. First, in Japanese accounting standards, as the background to not adopt the position of revising financial statements of previous years, the link between recording and settlement procedures in accounting books (booking procedures) and preparation of financial statements has been emphasized.

In our view, the process of closing the books at the end of the accounting period to confirm records is respected, and revisions after that are incrementally recorded after the next period. In other words, this concept puts emphasis on the idea that the recording and accumulation of transactions during the accounting period is the foundation of accounting, including performance measurement, and financial reporting is based on that operation.

Moreover, Japanese Commercial Code has the legal obligation to confirm calculation documents with approval in shareholders' meeting as a basic rule. This fact leads to the theory of excluding the revision of definite settlement of accounts, and the concept of not conducting the retroactive revision.

⁴² In the case of c., there are some examples of executing retroactive revision.

The Japanese financial reporting system is based on such bookkeeping procedures, and in consideration of institutional stability, is founded on the following two functions:

- i) Function to support decision-making on corporate and investment values for general shareholders including potential ones
- ii) Function to present basic figures and facilitate the adjustment of interests when corporate executives decide business performance in a certain accounting period and both the attribution and distribution of deposited properties at the end of accounting period for various stakeholders.

From the above viewpoint, since the benefits due to institutional stability, etc. are larger than demerits due to reducing, to some extent, ease of comparison, we should take a cautious attitude to the active amendment of accounting standards on retroactive revision. However, from the viewpoint of disclosure, it is considered effective to indicate some notes.

As for the “Critical errors caused in previous years” pointed out in c., retroactive revision should be appreciated. Since the retroactive revision due to c is revising an incorrect financial report to a correct one, is considered different from retroactive revisions due to a, b, and d, in which a correct financial report is changed to another correct one. There are already examples of such retroactive revisions related to “Critical errors caused in previous years”. This should be considered in the direction of executing as a general rule in future, after further clarifying requirements for critical errors.

(6) Special-Purpose Entities

In Japan securitized transactions using special-purpose entities (SPE) became fully conducted due to the securitization of leasing and credit loans, on the enactment of the Specific Obligation Law in 1993. After that, in the second half of the 1990s, financial assets such as loans from banks were more actively securitized in response to the regulation of equity capital, and the securitization of real estates was also fully started. Since laws to promote securitization (SPC Law, Perfection Law, Servicer Law, which were enacted in 1998) were organized in the second half of the 1990s, the securitization markets drastically expanded.

Presently, in addition to the type to transfer assets to special-purpose companies, SPEs developing real estate for leasing, housing, and commercial facilities have been broadly used, and thus the utilization of SPE is likely to expand. Not only the securitization of financial assets such as trade accounts receivable and loans, and real estates, but also the securitization of intangible assets such as relatively new business contents, have got started. Consequently, they are considered to play an important role in industrial policy, as the third method of fund-raising, other than direct and indirect finance.

With the utilization of SPE, it mainly aims to diversify methods of fund-raising, compress total assets by removing some assets from the balance sheets, reduce interest-bearing liabilities, and realize gains from sale of assets. Accordingly, in corporate accounting, in what kind of cases the disposal of assets is accepted, or SPE should be consolidated, is controversial.

In the case of ordinary companies, the pros and cons of consolidation are decided under the control of the decision-making organization (shareholders' meeting, and board of directors), and normally judged with equity ratio in the shareholders' meeting. However, in SPE, since the shareholders' meeting and the board of directors are structured not to function, in order to legally insulate held assets from related parties such as transferors, the pros and cons of consolidation cannot be judged by the decision-making organizations (shareholders' meeting, board of directors). In the case of such business entities in which the pros and cons of consolidation cannot be decided based on equity ratio, which should consolidate based on what kind of standards is problem at accounting.

In the Japanese accounting standards, the actual control standards are adopted for the judgement of consolidation, and make it possible to decide under the control of the company's decision-making organization (shareholders' meeting, board of director). Meanwhile, there is a special rule on consolidation of special-purpose entities. In the case of SPE fulfilling a certain requirement, for example, it was set up with the aim of having owners of securities issued by this SPE enjoy income generated from assets transferred at appropriate prices, and transferors of assets and investors to the SPE are supposed not to require consolidation.

In the U.S., in the wake of the Enron scandal (fraudulent accounting using SPE), there have been strong disputes on the consideration of SPE, and FIN46(R)" Consolidation of Variable Interest Entities – ARB51Guidance for Interpretation" was announced in December 2003. Undercapitalized entities of which total amount of equity is too small to operate the business without financial support from third parties are named "Variable Interest Entities". For such entities, owners of variable interest (main recipients) who have over half of the estimated losses and gains of an entity are supposed to consolidate.

SIC12 "Consolidation of SPE" was announced by International Accounting Standards. Whether SPE is controlled or not should be comprehensively examined, in consideration of i) business activities of SPE, ii) decision-making on SPE, iii) enjoyment of economic benefits, and iv) burden of risks.⁴³ Presently, IASB is in the midst of examination of "Consolidation (including SPE)" as the formal theme, to consider comprehensive consolidation standards capable of being applied to all entities including SPE.

In this way, as consolidation of SPE, international disputes have not been concluded yet. It is a subject currently being examined, and proper accounting standards are also sought.

In Japan, since the utilization of SPEs has been drastically expanding in a short time, and its purposes are varied, it is necessary to clarify the actual situation of utilization to consider accounting rules. For the time being, there may be the case that SPE owns important assets and liabilities for corporate activities. To express the actual business conditions as exactly as possible, adequate disclosure of information is required, even if entities are not consolidated but connected closely with SPE. In the current situation, there are no rules on disclosure, which are limited to SPEs, and only contingent

⁴³ It is pointed out that specific application of SIC12 is difficult without detailed guidance.

liabilities and others are disclosed. In future, it is necessary to consider the concept of disclosure related to SPEs.

(7) Accounting for Business Combinations

In the U.S. Accounting Standards and International Accounting Standards, only the purchase method is adopted as accounting for business combinations. Based on the present economic conditions, in which it is basically very rare that an acquiring party cannot be identified in business combinations, there is no room to adopt the pooling of interest method. This is because of the judgment that availability of information is higher only with the purchase method, or that it not necessary to set up specific accounting standards for very rare cases.

Meanwhile, in Japanese accounting standards, either the purchase method or the pooling of interest method are chosen, depending on the conditions. There are, to no small extent, cases of business combinations where the acquiring entity cannot be identified, as in the present economic conditions, from the viewpoint of promoting smooth business consolidation. In such cases, it is not considered appropriate to decide that one of them is the acquiring entity, and reevaluate assets and liabilities of the acquired entity, from the viewpoint that the actual business situation should be reflected in corporate accounting as well as possible. As long as there are different economic conditions, “acquisition” and “consolidation of equity”, it is considered rational to choose accounting treatment corresponding to the actual conditions, in order to improve representational faithfulness and comparability, and prepare more reliable information in corporate accounting. Internationally, it is necessary to adequately explain such actual economic situations and this concept of corporate accounting, and patiently work on other parties to reflect out that concept with international accounting standards.

As for accounting treatment for goodwill caused by application of the purchase method, not regular amortization, but accounting for the impairment of assets is conducted in the U.S. Accounting Standards and International Accounting Standards. This is because there is some doubt as to the availability of information on amortization based on certain premises, due to difficulties in objective measurement of the period to maintain the value of goodwill, and the pattern of decrease in the value. In adopting the method without amortization, intangible assets are obligated to be posted (intangible assets of which duration can be identified are amortized), and goodwill which is not amortized is supposed to be reduced without limit. Furthermore, one of the reasons that goodwill is not amortized is that a more precise diagnosis on impairment of assets has been established.

However, in Japan, along with accounting for the impairment of assets, regular amortization is also supposed to be conducted. This is because it is necessary to calculate the return on investment with regular amortization, like tangible fixed assets invested into business, to express the performance of acquired business appropriately, because goodwill is a prime cost of business investment. Such business performance expressed with regular amortization is considered to show the present business conditions, and to be useful for estimates of future cash flows. Furthermore, as the part of goodwill value which does not decrease cannot be separated rationally from the decreased part, it is considered desirable to base on regular amortization including the

parts that can not be separated, from the viewpoint of securing financial stability.⁴⁴

In the case of implementing only accounting for the impairment of assets, it is very difficult to judge whether accounting for the impairment of assets should be conducted or not, and to evaluate the after-the-fact value of goodwill, and there is some room for arbitrariness. In addition, when accounting for the impairment of assets is not properly conducted, there is a risk that a considerable amount of losses may be posted in future. Corporations may also be forced to bear the burden of a large amount of costs due to appropriation of intangible assets and judgement of impairment of assets. Moreover, there are many problems to deal with, for example, it is necessary to establish the evaluation method of goodwill value.

In the case of repeating corporate acquisitions without regular amortization, the case that the amount of goodwill in total assets becomes too large is likely, in consideration of the present trend of increasing corporate acquisitions. Consequently, there are problems from the viewpoint of corporate financial stability. When the corporate acquisition is implemented in the form of share exchange, the considerable amount of goodwill is possibly recorded due to excessively evaluated value. There is the opinion that the formulation of a reasonable purchase price can be promoted, while expressing business performance with regular amortization, too.

ASBJ is now minutely considering accounting treatment related to accounting for business combinations, and statements that, the method of accounting for goodwill similar to that of the U.S. Accounting Standards and International Accounting Standards should be adopted, have been made. ASBJ conducted the examination on the basis of those statements, and announced the “Applied guideline of accounting standards for business combinations and accounting standards for separation of business (draft)” in July 2005. In the public draft and reference data, the concept of accounting treatment for goodwill is organized, and handles goodwill as a depreciable asset. It was also suggested that the accounting method in which amortization on the day of business combined is implemented and special losses are posted should not be adopted.

In the midst of the advance of the global economy, such differences in accounting treatment could possibly have an effect on corporate activities, in the environment in which the number of international M&A is increasing. Therefore, this Study Group feels impelled to continuously advocate the validity of Japanese accounting standards for business combinations to Europe and the U.S., for the realization of convergence, in cooperation with the private and public sectors. Consequently, it is necessary to address this jointly with the economic and political parties concerned, including ASBJ, emphasizing disclosure of information accurately reflecting the actual economic situation, based on the above-mentioned concept, in order to support the continuous and stable growth of Japanese companies.

(8) Accounting for Leases

In the U.S. Accounting Standards and International Accounting Standards, when almost

⁴⁴ Even if the total value of goodwill in which goodwill generated through later business efforts is added to goodwill acquired with the acquisition is maintained or increased, the acquired goodwill could possibly be replaced by self-created goodwill generated through business efforts later, as time goes by. Consequently, it is inappropriate that goodwill is not amortized, leading to practically recognizing self-created goodwill as an asset.

all economic benefits and risks are transferred to a borrower of a leased property, those lease transactions are classified as finance lease transactions, and given selling and buying treatment or finance treatment (hereinafter referred as selling and buying treatment). Lease transactions other than finance lease transactions are classified as operating lease transactions, and given lease treatment. This is because finance lease transactions are considered to have economic actuality similar to sales by installment. In U.S. accounting standards, as specific judging standards to conduct actual selling and buying treatment, numerical standards are set as follows:

- 1) The lease period is 75% or more of the economic useful life of a lease property.
- 2) The present value of the total amount of lease payment at the start of lease is over 90% or more of a reasonable estimate, on the assumption that the borrower purchases the lease property.

Meanwhile, in Japanese accounting standards, the basic idea and accounting treatment such as the classification of finance lease and operating lease transactions, are the same. However, in certain finance lease transactions (finance lease transactions without title transfer), although selling and buying treatment is conducted as a general rule, lease treatment is also accepted, subject to the disclosure of data on explanatory notes similar to selling and buying treatment.

Currently, a number of companies adopt lease treatment as on exception, and ASBJ is considering the abolishment of this exceptional treatment.

From the standpoint that the exceptional treatment should be abolished,⁴⁵ it is asserted that since non-cancelable or full-payout⁴⁶ lease transactions have economic actuality similar to the case of selling and buying assets by installment, the same accounting treatment should be conducted. Now there is an abnormal situation in which the majority of companies have adopted not the principal method but the exceptional one, and the purpose of accounting standards that selling and buying treatment is designated seems to be ignored. Therefore, from the standpoint in favor of abolishment, the current situation should be corrected. Furthermore, the comparability of financial statements has been impaired, for example, financial ratios are different for selling and buying treatment and lease treatment.

From the standpoint of supporting the continuing existence of exceptional treatment, since lease transactions in Japan have a strong nature of lease,⁴⁷ and are multiple, including elements both service and finance, it is insisted that lease treatment is definitely desirable. The fact that concerned parties of transactions recognize them as lease transactions is verified by the generalization of lease treatment. Furthermore, the adoption of lease treatment would not substantially impair comparability, with the disclosure of detailed explanatory notes similar to the case of conducting selling and

⁴⁵ "Irrevocability" is considered to include lease transactions recognized irrevocable practically due to the payment of the considerable penalty at cancellation, even if it is cancelable legally.

⁴⁶ In "full pay-out", a borrower can enjoy the economic benefit generated through lease transactions, bearing the costs of use.

⁴⁷ Amortization, and declaration and payment of fixed asset tax is conducted during the lease period, and the lender is responsible for disposal after lease period. Lease contract is often renewed again after the completion of the contract.

buying treatment.⁴⁸

From the viewpoint that accounting information should reflect actual corporate conditions as closely as possible, it is important to fully consider the actual conditions of lease in Japan, and accounting treatment should be examined, based on the comparison of actual conditions of lease transactions in other countries. In that regard, it is essential to examine whether lease transactions in Japan should be limited to selling and buying treatment as a general rule, or if lease treatment should continued to be accepted.⁴⁹

Currently, the lease business in Japan is structured on the basis of Corporate Tax Law. There is the opinion that if accounting standards are unified to selling and buying treatment, items based on definite settlement of accounts influence tax treatment, and the foundation of lease business's existence may be impaired. As mentioned before, the principle of definite settlement of accounts and the requirements of recognizing as expense can be highly appreciated as aspects of the system with stability and economic rationality. However, in recent years, it is also true that corporate accounting is losing touch with tax accounting. While the tax system is defined from the political viewpoint, such as securing of tax revenues, corporate accounting ought to reflect the actual corporate conditions as well as possible. Consequently, although there is some room to examine this problem, the divergence of both is considered unavoidable, to some extent. From such a standpoint, it is necessary to examine the relationship between corporate accounting and tax accounting from the political viewpoint in regard to lease accounting, in full consideration of the situation in U.S. and Europe⁵⁰.

4. Further Responses for Future

Presently, Japanese accounting standards are practically established and revised by ASBJ. In the examination, opinions from a broad range of concerned parties including industries, scholars, and market players are put together, and this process is open to public. Also in the future examination by ASBJ, it is necessary to make continuous efforts to establish accounting standards reflecting the actual corporate management properly, based fully on the Japanese basic concept, as mentioned above.

Meanwhile, IASB is examining various controversial points such as performance reporting. Since many of those agendas are discussed in the joint projects of IASB and FASB, the West-centric tendency can be seen. Japan often has a different management style from Europe and the U.S. Therefore, it is necessary to make efforts to have our basic concept and advocacy include in their projects, through entry into the advisory group.⁵¹ Also in the government and industries, a network for exchange of opinions especially with European countries and the

⁴⁸ In the U.S., it is insisted that lease treatment is generally and practically adopted, numerical standards manipulated.

⁴⁹ It is necessary to examine the actual situation of lease in Japan, based on the report on examination by Japan Leasing Association ("Examination on lease accounting standards (report on the situation)") published in March 2005).

⁵⁰ In Europe and the U.S., lease treatment is adopted in taxation for transactions falling into finance lease transactions without title transfer. Even if selling and buying treatment is adopted in principle, lease treatment can be also adopted in the case of fulfilling numerical standards. (See Appendix 4 "Accounting Treatment and Tax Handling in Japan, Germany, France, U.K., and the U.S.")

⁵¹ The group to give advice on specific project to IASB

U.S.,⁵² is needed strong voice to IASB and FASB.

The Convergence Project conducted by ASBJ and IASB aims at the establishment of higher-quality single accounting standards. Even if Japanese accounting standards have already achieved an international level, it is desirable to actively promote this project, because it not only supports the global activities of Japanese companies, but also facilitates exchange of investment, and activates global markets. In this regard, we must make efforts to construct accounting standards fully based on Japanese basic concepts. As it is expected to take a lot of time to converge everything, it is essential to examine important items at an early stage.

Conclusion

Japanese accounting standards have reached the international level due to a series of Accounting Big Bangs, corresponding generally to the current actual situation of Japan. However, in consideration of the convergence in future, the revision of part of Japanese accounting standards is necessary. Internationally, individual problems such as performance reporting have been continuously discussed by IASB, in addition to individual problems discussed in the Convergence Project.

Along with the advance in the globalization of economic activities, for accounting standards as an infrastructure, it is desirable to share a single accounting standard internationally, in order to secure the availability and comparability of financial statements. Therefore, it is necessary to make efforts to converge accounting standards of various countries to approximate each other. At that time, adequate discussions are required to reflect the concepts of the industries and market players in each county.

In the discussion conducted presently by IASB, we are very concerned that we may possibly be called on to apply accounting standards and disclosure of information, losing touch with the actual corporate management. Disclosure of information cannot play the role of making decisions or adjusting interests, until the actual corporate management is appropriately expressed. We have to acknowledge that the usefulness of information that does not express the actual situation is low.

Corporate executives aim to improve their corporate value through continuous business activities, but do not expect to repeat buying and selling of business in the short term for an increase in corporate value. Based on this basic concept, it is considered useful to disclose information capable to express results from continuous business activities. Therefore, it is important to disclose information on “net income” useful to estimate future cash flows backed up with the concept of “release from risks”. As a result, the usefulness of information evaluating all including assets used for continuous business on fair value can be considered low.

It is necessary to have the above-mentioned basic Japanese concept fully reflected in the

⁵² European and U.S. major industrial organizations include UNICE (Union des confederations de l’Industrie et des Employeurs d’Europe, and FEI (Financial Executives International). In April 2004, the Japan Federation of Economic Organizations and UNICE announced a joint statement on International Accounting Standards. In this statement, they indicated concern about the concept that the evaluation at market value is adopted as a general rule in business reporting (on comprehensive income), which is under consideration by IASB, and also their attitude to work in cooperation to realize mutual acceptance for accounting standards. In this way, Japanese industries are going to cooperate with those European and U.S. industrial organizations continuously. ASBJ is urged to enhance their cooperation with FASB.

establishment of domestic accounting standards, and request to the main body to establish standards such as IASB, in cooperation with overseas industries.

In this report, the basic concept of the corporate accounting desirable for the Japanese economy was summarized, but does not cover all items necessary to be considered in the general corporate accounting. Further examination of the framework of the concept, mainly by corporate executives and investors, is needed.

We intend to make continuous efforts to address the development of higher-quality corporate accounting with a close exchange of opinions between ASBJ and the parties concerned with the establishment of standards, integrating opinions from related parties in various industries and markets, whether at home or overseas.

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References

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Evaluation and Assessment of Japan's Accounting Big Bang

1. Background

The “Accounting Big Bang” refers to a series of efforts to substantially transform the Japanese accounting system, which were implemented beginning in the latter half of the 1990s as part of reforms in financial and securities market infrastructure after the collapse of the economic bubble. As economic activity became more globalized and the business environment drastically changed, enterprises shifted from individual company-centered management to group management, and there were increased moves toward industrial restructuring due to the necessity of enhancing international competitiveness. Corporate management practices also changed considerably, leading to a need for accounting systems capable of properly reflecting those practices. And with an increase in funds coming from foreign countries, it became necessary to improve the reliability of financial data for foreign investors.

In the course of the Accounting Big Bang, numerous accounting standards were revised, and others were newly established. Among them, the one that stands out most may be the conversion into disclosure centering on consolidated information. Until the economic bubble collapsed, companies aimed to expand the scale of business, operating various businesses, and centering on activities by individual companies. However, after the collapse of the economic bubble, greater efficiency and speed are required. In a word, there is now a need to review excessively expanded organizations, promote spin-offs, accelerate business proceedings, and conduct management judgement for the group as a whole to aim at more efficient overall business. Accompanying the changes in corporate management, in accounting, stress was put on disclosure centering on consolidated information, to disclose the actual corporate management of corporate groups appropriately.

Since assets were previously evaluated with acquisition costs in principle, assets with latent loss and return were only partly disclosed as explanatory notes, and never reflected in the main body of financial statements. However, for the purpose of expressing the actual financial situation and business performance, the method of evaluating financial instruments at fair value was introduced. Even in this case, since considering the purpose of holdings leads to further appropriate disclosure, a treatment method corresponding to the purpose of holdings was determined, based on evaluation at fair value.

Furthermore, due to a slowdown in the economy, the fall in the operating interests of assets, and the occurrence of latent loss of assets, whether the assets necessary for future corporate pension benefits could be secured or not became a matter of concern. As this problem was likely to lead to deterioration of corporate financial conditions, the importance of information on corporate pension drastically increased. Therefore, accounting standards related to retirement benefits were newly established.

In the final stage of the maintenance of Japanese accounting standards, caused by the Accounting Big Bang, the accounting standards for impaired fixed assets were developed. As prices and profitability of fixed assets such as real estate substantially decreased, there was concern that losses would be deferred to the future due to leaving book values excessively high. These standards were newly set up because the appropriate accounting treatment had not

been developed yet. These accounting standards are required to be applied from the beginning of the business year after April 1, 2005, but it is acceptable to apply them from the end of the business year after March 31, 2004. Many companies have already started the application to disclose the financial situation and business performance of their own companies appropriately.

In this way, Japanese accounting standards were forced to reform rapidly by the Accounting Big Bang, in parallel with the rapid changes in market environments and actual business conditions. Moreover, along with the advance in the internationalization of markets, international harmonization has become an important issue. From the viewpoint of the Japanese economy and industry, how such a series of changes is evaluated was examined and summarized.

2. General Theory

Through the Accounting Big Bang, transparency and reliability of corporate accounting improved and facilitated an increase in private and foreign investors. Such changes in the shareholders' composition influenced corporate activities, for example, the demand from shareholders to corporate executives changed, the selection of assets held by companies advanced, and IR activities were emphasized.

Although the Accounting Big Bang was introduced in the midst of a slump in the entire Japanese economy, latent losses which corporate executives did not recognize and the deteriorating debt situation were clarified through the changes in the economic environment such as the fall in the prices of land and shares. For the entire economy and industry, the Accounting Big Bang contributed to the improvement in financial structure. In other words, the financial structure was restrained from deteriorating further: for example, it became difficult to conduct income manipulation such as management of unrealized long-term capital gains and deliberate disposal (tobashi). This facilitated rational corporate activities, and as a result, improved the efficiency of assets and led to the steady shift of business performance.

From the viewpoint of employment and capital investment, the following matters were pointed out:

- 1) For employees, the long-term, stable employment system was driven to collapse.
- 2) For the economy and industry as a whole, since it became difficult to foster personnel for the long term without securing employment, corporate ability to grow slowed down. Also, due to the restraint of capital investment, economic growth faced a temporary stagnation.

However, for the long and middle terms, will or choice of assets including personnel and allocation of resources were appropriately conducted, successfully preparing for the growth after that.

The Accounting Big Bang, partly influenced by overseas accounting standards, was introduced, corresponding to changes in the economic situation such as failures of financial institutions. As a result, it can be said to have contributed to the fostering of global markets, through gaining international trust of Japanese financial and securities markets.

Furthermore, globally active foreign companies highly appreciated the Accounting Big Bang that facilitated their economic activities in Japan.¹ This indicates that foreign countries recognized the Accounting Big Bang as promoting the maintenance of infrastructures of markets through the international harmonization of Japanese accounting standards.

Meanwhile, in the positive analysis study on the effect on price formation of securities markets from the introduction of accounting standards, the Accounting Big Bang was found to have had positive effects on corporate management and economic systems.² According to the study, the decrease in the buying and selling spread was caused by the review of the scope of consolidation and the introduction of accounting standards for financial instruments, and finally the liquidity in the market was considered to improve. Furthermore, in the analysis of the relationship between the Accounting Big Bang and cross-shareholding, it was found that the cross-held shares were definitely eliminated with the review of the scope of consolidation and the introduction of accounting standards for financial instruments. In the survey on movements in share prices of the company selling off those cross-held shares, Tobin's q (the ratio of the market value of a company and costs for replacement of company's assets)³ increased. In other words, cross-held shares were sold off to maximize business performance measured with Tobin's q . The higher the business risks a company has, the more it promotes the elimination of cross-held shares to reduce the burden of additional risks caused by cross-shareholding. Market risks thus restrain the effects of business performance. Consequently, as seen in the fact that the elimination of cross-shareholding is conducted to maximize business performance, the review of the scope of consolidation and the introduction of accounting standards for financial instruments can be said to contribute to rational decision-making about the allocation of corporate resources.

Since the introduction of excessive evaluation on fair value in the future may increase elements for estimation and forecast, it is expected that the transparency will become considerably lower for stakeholders such as investors, and that preparation and organization of a huge quantity of documents will be required. Accordingly, there is the possibility of causing adverse effects such as a heavier burden on the entire economy and industry.

3. Review of the Scope of Consolidation

The growing awareness of consolidated group management led to the elimination of income manipulation such as shuffling clients' investment losses and the improvement in usability of information for stakeholders such investors. Also for the entire economy and industry, the allocation of resources came to be conducted in consideration of the efficiency of the entire group, the restructuring inside a group was promoted and economy became more active.

¹ According to "The 7th survey on foreign companies' attitude to direct investment in Japan" by JETRO (January 2002), the questionnaire survey to ask what measures were especially effective to improve the business environment of foreign companies in Japan was conducted. In that survey, the introduction of international accounting standards was highly appreciated, at 42.5%, following the 59% who appreciated the decrease in the effective corporate tax ratio. (multiple answers allowed)

² According to the "Report on experimental analysis of influences on corporate management and economic systems for the establishment of new accounting standards" by METI (May 2003)

³ "Tobin's q " is calculated by dividing the total amount of total market value of shares and debt with interest (market value of a company) by the invested capital (replacement costs) with revision of unrealized loss and gain of lands and securities. Consequently, an increase in this numerical value means that it is easier to assess the premium of business acquisition with higher precision of the evaluation of excessive profitability, thanks to easier calculation of actual corporate value. If Tobin's q is large, it means that that company's effective use of assets and facilities is highly evaluated by the market. ("Experimental analysis of reform of accounting standards," p. 74, edited by Kazuyuki Suda; Dobunkan Publishing Co.; October 2004)

Due to the introduction of the disclosure of consolidated calculation documents and the consolidated taxation system in the Commercial Code, there is the opinion that the demand for consolidated dividends is increasing in recent years.

Although the consolidated group management is spreading, which is used as the basis of assessment for bonus and compensation, consolidated income or individual income, employees and corporate executives possibly have different opinions on this. From the standpoint of employees, the assessment system by an individual company is often maintained to make incentives for improvement in the business results of a person's own company work effectively, and there is the possibility that the ground of assessment for bonuses is not necessarily linked with the consolidated income. However, from the standpoint of corporate executives, to evoke awareness of consolidated group management, and make incentives for improvement in consolidated business results more effective, consideration of developing a compensation system based on consolidated income has started.

Even after management shifted to a consolidated group, there is still the system based on an individual company such as the regulation of interests left. Also, since needs for information of individual financial statements still exist in the evaluation of business performance and other matters, where to position separate financial statements is left as a future problem.

4. Evaluation of Financial Instruments at Market Value

As a result of the advance in elimination of cross-shareholding due to the evaluation of financial instruments at fair value, the number of individual and foreign investors increased, the enhancement of IR and the reform of governance was promoted, and more appropriate information disclosure spread. Therefore, the evaluation of financial instruments at fair value made it possible to apply the brakes more effectively to the selection of assets with low efficiency and necessity, and can be said to promote corporate activities that are desirable for stakeholders such as investors. Furthermore, the connection among companies became weaker due to the elimination of cross-shareholdings, and thus some industries feel that they are unable to conduct stable management, and the risks of M&A have increased. Consequently, future countermeasures to address those problems as the entire economy and industry are being considered. Although it is pointed out that sale of shares for elimination of cross-shareholdings is one of the causes of the further fall in share prices, on the other hand, it can be said to promote the increase in the number of individual and foreign investors, and to activate the markets after that.

The concept that the evaluation of financial instruments for selling and buying at market value, which was introduced by the Accounting Big Bang, is not contradictory at all from the viewpoint of the traditional accounting concept based on "release from risks" and acquisition costs and feasibility of instant conversion to cash, and expresses the actual corporate management appropriately, has become popular.

The changes in accounting standards made corporate executives more conscious of market value, and became one of the triggers to generate changes in corporate activities, in the situation in which changes in the structure occurred after the collapse of the economic bubble.

5. Accounting for Retirement Benefits

Since the introduction of accounting for retirement benefits actualized potential costs and liabilities, it can be said that the actual business conditions are appropriately disclosed, and that the usability of information improves for stakeholders such as investors. Furthermore, for the entire economy and industry, caution arose in relation to burdens and risks in management, the postponement of problems was avoided, and thus the financial structure was enhanced as a result.

With the introduction of the retirement benefit trust, the partial or full return to companies of pension assets under agency management by government, and the system of using Commercial Code financial statements affirmed at shareholders' meetings, companies launched into the reduction of retirement benefit obligations, and eventually financial health improved. Therefore, for investors, a sense of security concerning items invested in increased. For creditors, risk management can be appropriately conducted due to the clarification of the future corporate burden. For corporate executives, it led to the review of the compensation system including the role of retirement benefits. For employees, since incentives for long-term employment decreased, the development of the fluid labor market and reallocation of personnel resources took place.

In general, for the economy and industry as a whole, share prices fell due to the active return of the employee pension fund, and self-responsibility became more recognized, while the traditional management system features such as lifetime employment and promotion by seniority changed with the introduction of defined contributions. As a result, although some people began to feel insecure about their future, and consumption behavior was negatively influenced, it can be also said that risks of corporate bankruptcy in the future have been reduced, transparency of the market has improved, and the number of investors has increased.

6. Accounting for Impairment

Due to the advance in reduction of nonperforming assets, it became easier for stakeholders such as investors to evaluate the efficiency of assets. For creditors, it has become easier to accurately judge collectability. For the economy and industry as a whole, although some corporate behaviors focusing on efficiency sometimes had adverse effects on local societies, the selection of assets took place at the right time, leading to the regeneration of business.

Even if losses are posted on accounting, there is a restraint on inclusion in expenses for taxation. Since both are unrelated to each other, in the case of putting emphasis on cash flows, there is the possibility of disposing of assets at an early stage. Although there is concern that it would lead to lower prices of assets, it can be also considered that more effective use of assets would occur due to the increase in fluidity, and as a result, the economy would be activated as a whole.

Current Status of Convergence and the Assessment of Equivalence

1. Status of Convergence

(1) Convergence Project by FASB and IASB

1) Background

In the joint meeting between IASB and FASB held in September 2002 in Norwalk, U.S., the project for convergence with U.S. standards was decided. The purpose is to reduce differences between IAS/IFRS and U.S. standards to improve compatibility, and finally to achieve convergence of accounting standards.

2) Results of Project So Far

IASB has announced three standards including IFRS No.2 "Share Compensation" which was integrated with U.S. standards, IFRS No.3 "Business Combinations", and IFRS No.5 "Fixed assets held for sale and discontinued operations". On the other hand, FASB has announced SFAS No.151 "Inventory Costs – an amendment of ARB No.43 Chapter 4" which was integrated with International Accounting Standards, SFAS No. 153 "Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29", and SFAS No. 154 "Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and SFAS Statement No. 3".

3) Items under Consideration

Presently, FASB and IASB are considering the following items (main standards-setting entity to address convergence in parentheses).

(i) Joint Project

In the Joint Project, both standards-setting bodies agreed to promote the project with the same time schedule, in cooperation with each other. The project is being jointly promoted, aiming to set up a new single set of standards and revise the existing standards, including the following items:

- Conceptual Framework
- Financial Performance Reporting by Business Enterprises
- Business Combinations
 - Phase II – Application of purchase method¹
 - Equity of minority²
- Revenue Recognition

¹ As part of this project, IASB and FASB published "Amendment to IFRS No.3" and "Business Combinations: a replacement of SFAS No. 141", public drafts to revise existing accounting standards to promote accounting treatment based on the concept of single economic entity, in June 2005.

² As part of this project, IASB and FASB published public drafts including "Amendment to IAS No. 27, Consolidated and Separate Financial Statements" and "Consolidated Financial Statements, Including Accounting and Reporting for Non-controlling Interests in Subsidiaries - a replacement of ARB No. 51", in June 2005.

(ii) Short Term Convergence Project

In the Short-term Convergence Project, differences considered to be able to be dissolved so as to achieve convergence in the short term are the object. As a general rule, the project integrates one accounting standards-setting body into another one, including the following items:

- Earnings per Share (FASB)³
- Income Tax (FASB/IASB)
- Provisions (IASB)⁴
- Amendment to IAS No. 20 (governmental subsidy) (IASB)
- Segmental Disclosure (Replacement of IAS No. 14)(IASB)
- R&D (FASB)

(2) Convergence Project by ASBJ and IASB

1) Background

Mr. Tweedie, Chairman of IASB, made a suggestion about the launch of the convergence project between ASBJ and IASB, in July 2004. ASBJ and IASB started talks on the launch of the joint project to reduce the differences in existing standards as much as possible, with the final goal being to achieve convergence of accounting standards, October 2004.

2) Procedures of work

ASBJ and IASB agreed to examine the differences in existing standards, to promote international convergence to achieve high-quality accounting standards. Matters agreed on are as follows:

- (i) The boards will identify and assess differences in their existing standards on the basis of their respective conceptual frameworks or basic philosophies with the aim of reducing those differences where economic substance or market environments such as legal systems are equivalent.
- (ii) The boards will address the differences in their respective conceptual frameworks. This will take place later in the project, as a separate subproject, at a time agreed by the boards.
- (iii) The ASBJ will undertake a study to get an overall picture of major differences between Japanese accounting standards and IFRSs and will identify topics to be discussed.
- (iv) The scope of the first phase is standards in place as of 31 March 2004, with the following exceptions:
 - standards under review or intended to be reviewed in the joint projects between the IASB and the US Financial Accounting Standards Board

³ As part of this project, FASB published the public draft “Earnings per Share: Amendment to SFAS No. 128” in December 2003.

⁴ As part of this project, IASB published the public draft “An amendments of IAS No. 37, Provisions, Contingent Liabilities and Contingent Assets and IAS No. 19, Employee Benefits” in June 2005.

(FASB)

- standards that are divergent owing to differences in the respective conceptual frameworks or basic philosophies
- standards recently developed
- standards whose requirements are subject to legal restrictions or those currently considered inapplicable in Japan

Matters that are not included in subjects of examination in the first phase will be examined in the later phase.

3) Items to examine in the first phase

In the joint meeting of ASBJ and IASB in March, it was agreed that the following five items would be continuously discussed as subjects to examine in the first phase.

- (i) Measurement of inventories (centering on the pros and cons of applying the cost or market method in Japanese standards)
- (ii) Unification of accounting policies applied to foreign subsidiaries
- (iii) Related Party Disclosures
- (iv) Segment Reporting
- (v) Investment Property (centering on the definition in IASB and the pros and cons of selective application of evaluation at cost or fair value)

Topics concurrently undertaken by the ASBJ, such as the introduction of the statement of changes in equity and accounting standards for share-based payment, were also recognized as contributing to convergence. Five topics for the first phase of the project will be deliberated on by each board.

4) State of Joint Project

Following the first meeting, the next meeting is scheduled to be held at the end of September in London. ASBJ started specific activities since May, by organizing the system, to obtain results from items examined in the first phase in a few years. As for the evaluation standards of inventory designated as the object of supplementary measures with technical advice from CESR, a special committee is supposed to be set up to announce the draft to the public in the first half of 2006. Furthermore, to examine the integration of accounting standards of overseas subsidiaries in preparing consolidated financial statements, the discussion on the review of the existing guidelines is planned to start in the practical response commission, with announcing the draft to the public scheduled for 2005.

2. Assessment of Equivalence by Commission of European Communities

(1) Background

The EU (European Union) has obligated listed companies inside the EU to use International Accounting Standards for preparation of consolidated financial statements since 2005, in order to integrate accounting standards and the infrastructure of capital market, as part of the integration of financial markets in EU.

In the disclosure regulation conducted as part of the integration of financial markets, the disclosure at issuing (prospectus) is integrated with the prospectus directive, and the regular disclosure (annual report and others) with the transparency directive.

Both directives obligate companies based outside the EU to offer their shares to the public and have them listed on EU markets to use International Accounting Standards or another set of standards deemed equivalent, in order to ensure the integrated application. The time to apply both directives was postponed until January 2007, and the mechanism to evaluate the equivalency of accounting standards of countries outside the EU was set up.

(2) Assessment of Equivalence

To carry on the mechanism of assessment of equivalence obligated by both directives, the Commission of European Communities ordered the Committee of European Securities Regulators (CESR) to give technical advice on the assessment of equivalence of the specific third standards (Japanese, U.S., and Canadian standards) in June 2004.

CESR published the “Concept Paper on the Equivalence of Certain Third Country GAAP and on the Description of Certain Third Countries’ Mechanisms of Enforcement of Financial Information (Consultation Paper)” (hereinafter referred to as “Concept Paper”) to clarify the definition of equivalency, and the method and criteria for technical evaluation of equivalence, and invited public comments. The Financial Services Agency, the Japan Federation of Economic Organizations, and ASBJ submitted comments on the purpose of equivalency, technical evaluation, and supplementary measures.⁵ The

⁵ The comments on the Concept Paper from the Financial Services Agency, Japan Federation of Economic Organizations, and ASBJ can be summarized as follows:

(1) Purpose of Equivalency

- It is necessary to make efforts to secure a fair, impartial, and transparent process, putting emphasis on the opinions of concerned parties with abundant and practical knowledge and experience of Japanese accounting standards.
- As for the judgement of investors, the opinions of institutional investors with expertise on Japanese standards should be taken into account. Actually, institutional investors in the EU are investing a huge amount of money in Japan, trusting Japanese accounting standards.

(2) Items covered in International Accounting Standards

- As for the requirement that items similar to IAS should be covered, equivalency should not be denied, if that item is not linked with the issuer of securities.

3. Technical Evaluation

- CESR was asked to take accounting standards that were already decided to be introduced before January 1, 2005, and will be forced to be applied from January 1, 2007 in to account.
- The standards that are under development now and expected to be applied by 2007 (stock option) should be evaluated, too.
- Not only a simple comparison, but also the viewpoint on whether differences are rational or not should be considered.
- In technical evaluation, only important differences should be focused on. It is important not to conduct excessively minute technical comparison, or to put emphasis on symbolic differences.
- In the evaluation of equivalency, in addition to the securing of investor protection, the priority should be put on the promotion of global and open features of the EU capital market and the securing of investment opportunities for investors in EU capital market.

(4) Supplementary Measures

- Among supplementary measures, adjustment statements and supplementary statements are not appropriate from the cost-to-benefit viewpoint.

summary of the final version of the Conceptual Paper published in February 2005 are as follows:

1) Objective of equivalence

“Equivalent” does not mean “identical”. When it is possible for investors to make a decision on investment similar to the case based on financial statements complying with International Accounting Standards, while actually based on ones complying with accounting standards of third nations, it can be declared to be “equivalent”.

2) Review of general principles

To evaluate the general rules, CESR considers the following:

- (i) Whether standards of the third nation has the four traits of appropriateness for purposes, understandability, reliability, and comparability, which are equivalent to International Accounting Standards, or not.
- (ii) Standards of the third nations must include standards and principles covering the same items as in International Accounting Standards.⁶
- (iii) Standards of the third nation must have the same purposes as International Accounting Standards (the purpose is to present investors with information useful for their decision-making).

3) Technical assessment

Evaluation of standards of the third nations has been in effect from January 1, 2005.⁷

The analysis is limited to important differences extracted and known practically by parties concerned with finance and audit of the EU and the third nations.

4) Remedies

When the standards are not equivalent, it is necessary to revise and indicate them again as remedies. In the intermediate case, it is required to prepare additional

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- Although additional disclosure is limited to the case when there are differences in disclosure regulations, differences in accounting treatment should be the object for additional disclosure. The contents of disclosure should be limited to qualitative ones.
 - As for supplementary measures, clear guidance is needed to facilitate the judgement by companies and auditors.

- As for the frequency of reevaluation, every year is too often, and once every three years may be appropriate.

⁶ As stated in the Concept Paper, the judgement is conducted depending on whether it covers IAS or not. However, due to such a lack of standards, validity would be judged at the level of an issuing body. (Concept paper on equivalence of certain third-country GAAP and on description of certain third countries' mechanism of enforcement of financial information, Feedback Statement para. 41).

⁷ AS stated in Concept Paper, CESR is supposed to consider accounting standards to be applied in the fiscal year starting on January 1, 2005, and thereafter. However, since problems on equivalency would occur after the transitional period of the transparency directive and the prospectus directive, it is scheduled to indicate notifications on important changes in standards of the third nations, which are expected to apply effectively during that period, in the report to the EC. For this purpose, in the questionnaire to the third nations, there are questions about standards scheduled to apply after January 1, 2005 and implemented before January 1, 2007. (Concept Paper, Feedback Statement para.36-38)

disclosure, statements of reconciliation, and supplementary statements, while standards are temporarily recognized to be equivalent.^{8,9} It is considered appropriate to reevaluate the equivalency evaluation in such an intermediate case regularly.¹⁰

(3) Assessment on Standards of the Third Countries by CESR

CESR published “Technical Advice on Equivalence of Certain Third Country GAAP” (hereinafter referred as “Technical Advice”) on July 5,¹¹ after publishing the draft on technical advice on equivalency of standards of the specific third countries to the Commission of European Communities in April 2005, and invited public comments broadly, based on the Conceptual Paper.

In Technical Advice, standards of the third nation requires supplementary measures, but are evaluated to be equivalent to International Accounting Standards as a whole. Consequently, CESR says reconciliation sheets are not needed between Japanese, U.S., and Canadian standards, and International Accounting Standards. However, additional narrative and/or quantitative disclosure (disclosure A), quantitative indication of the impact of an event on transaction (disclosure B), and remedies (pro-forma financial statements on the basis of hypothetical calculation) are required.¹²

In Technical Advice, remedies are required for the following:

1) Preparation of pro-forma financial statements on the basis of hypothetical

⁸, Additional disclosure or qualitative disclosure about differences alone, without amendment of financial statements, is considered inadequate. (Concept Paper, Feedback Statement, para.49)

⁹ The list of supplementary measures to be applied is supposed to be presented by standard, clarifying the reporting regulations on issuers of the third nations. (Concept Paper, Feedback Statement, para. 51)

¹⁰ It was suggested that reevaluation would be conducted on January 1, 2007 for the first time, and after that, regularly conducted on June 30 every year. (Concept Paper, para. 75)

¹¹ After the announcement of the advice, CESR conducted a review based on public comments. As a result, contents of the advice were maintained regarding the following points: 1) Japanese, U.S., and Canadian accounting standards are regarded as equivalent as a whole, and 2) certain supplementary measures are required in the case that there is an important differences from IAS.

Meanwhile, the following items were revised:

1) Items on supplementary measures are slightly reduced. (As for the Japanese standards, the additional disclosure regarding differences caused by applying accounting for impairment of fixed assets was deleted.)

2) The consolidation of a special purpose entity (SPE) is limited to the consolidation of qualified SPE.

3) As for items that are not included in the list of important differences, the objects are limited to the case regarding transactions and phenomena particular to a specific industry, and the case regarding exceptional transactions and phenomena leading to other exceptional accounting treatment, excepting the case that additional disclosure is necessary.

¹² Additional qualitative and quantitative disclosure (disclosure A) is the expanded version of the qualitative and quantitative disclosure prepared in the third-nation standards. For example, the explanation of related transactions and phenomena and their accounting methods, the indication of assumptions and evaluation methods used for measuring and recognizing transactions and phenomena, and the disclosure of fair value of assets are required.

As the indication of the influenced amount (disclosure B), it is required to indicate the quantitative influences (influences on losses and gains, and shareholders' equity before and after tax) in the case of conducting accounting treatment for phenomena and transactions in accordance with IAS.

Supplementary statements are pro-forma financial statements prepared and indicated on the basis of the accounting rules and the major financial statements for the issuing corporation of the third-nation standards to correct specific items to redress a lack of equivalency. However, it does not aim to indicate financial conditions and profits complying with all clauses of IAS.

calculation with supplementary statements consolidating a qualified special-purpose entity (QSPE) which has not been consolidated (Japan, Canada, and U.S.).

- 2) Preparation of pro-forma financial statements on the basis of hypothetical calculation with supplementary statements on respective differences related to business combinations (pooling of interest method) and the integration of accounting standards of overseas subsidiaries (Japan)
- 3) Implementation of the expensing of stock options on and before January 1, 2007 (Japan, U.S.)
- 4) Additional qualitative and quantitative disclosure on differences related to other specific standards (Japan, U.S., Canada)

It is supposed that the necessity to apply the supplementary measures above is judged for each company, and evaluated by auditors.

3. Responses of Japan

As for problems related to accounting standards in 2007, mainly the Financial Services Agency has actively requested concerned parties such as members of the Commission of European Communities and major EU nations, to have Japanese accounting standards recognized to be equivalent to International Accounting Standards.

The Financial Services Agency has steadily worked on the acceptance of Japanese accounting standards by EU members politically and technically. Furthermore, since it was pointed out that there is the mistaken perception that Japanese accounting standards are behind International Accounting Standards, PR on Japanese standards has been actively conducted, using English brochures.¹³

The Ministry of Economy, Trade and Industry established the “Study Group on Internationalization of Business Accounting” in December 2003, to address the assessment of equivalence and convergence issues, based on the needs of industries and market players in Japan. In the report of this study group, “Report on Internationalization of Business Accounting”,¹⁴ opinions of domestic concerned parties on efforts for the realization of mutual acceptance, the solution of legend issues, and international convergence were covered. With this report, CESR, the Commission of European Communities, and concerned parties of EU have also been asked to understand that Japanese accounting standards are internationally

¹³ See pp. 91-92 of “Outline of EU prospectus directive and transparency directive – the assessment of equivalence of Japanese accounting standards” by Naohiko Matsuo (Commercial Law No. 1705, Aug. 5, 2004)

¹⁴ The following ideas are indicated:

- 1) Based on the views of not only Japanese market players such as investors, but also European and U.S. companies and investors in Japan, and in the light of standards such as usability, comparability, reliability, and transparency, it is considered that Japanese accounting standards are at a level equal to IAS or the equivalent, in spite of the existence of minute technical differences.
- 2) The abolishment of appending legends is persistently requested of business partners in Europe and U.S., through Japanese audit corporations.
- 3) The Japanese government considers that adequate discussion and agreement is necessary for this project to integrate accounting projects. It is important to work on the project, making efforts to achieve the long-term target, and sharing the concept with the U.S. and Europe.

equivalent. In addition, the importance of establishing equivalency not only for the future development of European markets, but also for promotion of investment into the EU, and mutual economic development including industrial cooperation between Japan and the EU have been explained.

The Financial Services Agency; The Ministry of Economy, Trade and Industry; ASBJ; Japan Economic Federation, and the Japanese Institute of Certified Public Accountants sent written opinions on the draft on technical advice announced by CESR in April 2005.

In these written opinions, it is appreciated that CESR concluded that Japanese accounting standards are equivalent to U.S. and Canadian standards as a whole. However, it is also pointed out that CESR should not focus just on trivial technical differences, but on differences substantially influencing investors' decisions, fully based on the basic concept of the Concept Paper.

There is concern that remedies indicated in the draft of advice would be disadvantageous to investors in EU. This is because they would surely impose considerable costs on the corporate side and could not be compatible with the securing of global and open features of the EU market, and investment opportunities in the EU market could not be compatible.

Among remedies, additional numerical data and supplementary statements, in particular, would make the preparation of two financial statements unavoidable as a result, and consequently could deny access of Japanese companies to EU market practically.

Therefore, it was requested of CESR that the application of additional numerical data and supplementary statements should be strictly limited.

Moreover, in the advice, there are items in which technical differences that are not actually important for investors' decisions, are considered important. Therefore, it was requested that differences caused by such technical details should not be regarded as important.

In addition, regarding "Comprehensive Clauses on Important Differences in Accounting Standards"¹⁵ included in the advice, it was pointed out that the authorities concerned should indicate clear guidelines and the best practice to make judgements about the importance of the application of supplementary measures by companies and auditors easier, and to avoid excessively conservative application.

The technical advice submitted by CESR is scheduled (beginning of 2006) to be considered for the final decision on equivalency evaluation in the Commission of European Communities in the future.

¹⁵ Even if it is an item that is not included in the list of important differences in accounting standards, but if it is independently regarded to be an important difference by the company and the auditor, supplementary measures are necessary (third clause of the Advice).

Outline of Corporate Accounting Systems in Japan, Germany, France, the U.K., and the U.S.

* As for corporate accounting system in Germany, France, and U.K., the situation before applying IAS law is indicated.

	Japan	Germany	France	U.K.	U.S.
Outline	Accounting in Commercial Code and Securities Exchange Law coexisting	Mainly accounting in Commercial Code	Mainly accounting in Commercial Code	Mainly accounting in Corporate Law	Mainly accounting in Securities Exchange Law
Accounting Standards	Same in consolidation and individual	Same in consolidation and individual in principle In case of applying different standards exceptionally, backed up legally	Applying accounting standards for consolidation (CRC) different from individual	Same in consolidation and individual	Same in consolidation and individual in principle However, usually not disclosing individual
Consistency of consolidation and individual	Requested However, consolidated financial statements on U.S. standards of companies registered to SEC are accepted, and in that case, the consistency cannot be maintained.	Requested However, consolidated financial statements on U.S. and IAS/IFRS standards are accepted, and in that case, the consistency cannot be maintained.	Not requested IAS/IFRS acceptable just for consolidation	Requested	Not clarified
Acceptance of IAS/IFRS (Note 1)	Not accepting	Accepting	Accepting	Not accepting	Not accepting
Acceptance of U.S. Standards (Note 1)	Accepting consolidated financial statements in U.S. style of companies registered to SEC	Accepting	Not accepting	Not accepting	/
Tax Accounting	System of using Commercial Code financial statements affirmed at shareholder's meeting Deductible expense accounting requirements and calculation of profit base	System of using Commercial Code financial statements affirmed at shareholder's meeting Deductible expense accounting requirements and calculation of profit base	System of using Commercial Code financial statements affirmed at shareholder's meeting Deductible expense accounting requirements and calculation of profit base	Declaration and adjustment method Deductible expense accounting requirements and calculation of profit base are not explicit	Separate method Deductible expense accounting requirements and calculation of profit base are sometime imposed exceptionally (Note 2)

	Japan	Germany	France	U.K.	U.S.
Relationship between corporate income and taxable income (Note 3)	There is tendency that corporate and taxable income are losing touch with each other with the increase in items to adjust.	Corporate income working with taxable income with less items to adjust	Corporate income working with taxable income with less items to adjust	Corporate and taxable income has loosed touch with each other, with traditionally many items to adjust.	Taxable income calculated separately from corporate income
Relationship between accounting in Securities Exchange Law and Commercial Code	There are regulations on accounting in Securities Exchange Law and Commercial Code respectively.	Agree to accounting in Commercial Code	Agree to accounting in Commercial Code	Agree to accounting in Corporate Law	Without regulations particular to Corporate Law, accounting in Securities Exchange Law is used for Corporate Law.
Corporate income and income available for dividend	Adjusting unrealized income included in corporate income	No adjustment without unrealized income in corporate income	No adjustment without unrealized income in corporate income	Adjusting unrealized income included in corporate income (Note 4)	Basically no adjustment, because of being based on retained earnings in accounting
Consolidated dividend	Cannot pay dividend based on consolidated financial statements	Cannot pay dividend based on consolidated financial statements	Cannot pay dividend based on consolidated financial statements	Cannot pay dividend based on consolidated financial statements	In California general corporate law, dividend is regulated on the basis of retained earnings in consolidated financial statements explicitly. Also in other states, dividend regulation is practically conducted on the basis of retained earnings in consolidated financial statements.

(Note 1) Whether IAS/IFRS and U.S. Standards are acceptable for preparation of financial statements of domestic company or not is indicated.

(Note 2) In case of adopting last-in first-out method to evaluate inventory in taxation, it is required to be appropriate in corporate accounting.

(Note 3) See Appendix 4 “Accounting Treatment and Tax Handling in Japan, Germany, France, U.K., and U.S.,” for the gap in major items between corporate and taxable income

(Note 4) When securities companies and others comply with laws and accounting rules accepted generally, evaluate investment, etc. at fair value in the market, and post income caused by it on balance sheets, it is handled as realized income.

Appendix 4

Accounting Treatment and Tax Handling in Japan, Germany, France, the U.K., and the U.S.

(* As for accounting, treatment on individual settlement is indicated.)

	Japan	Germany	France	U.K.	U.S.	IAS/IFRS (Reference)
Allowance						
Accounting	Posting retirement benefits obligation in consideration of actuarial calculation for pension	Posting retirement benefits obligation without considering actuarial calculation for pension (Note 1)	Not force to post retirement benefits obligation	Posting retirement benefits obligation in consideration of actuarial calculation for pension	Posting retirement benefits obligation in consideration of actuarial calculation for pension	Posting retirement benefits obligation in consideration of actuarial calculation for pension
Taxation	At payment, inclusion in expenses	At occurrence, inclusion in expenses	At payment, inclusion in expenses	At payment, inclusion in expenses	At payment, inclusion in expenses	
Other liability allowance						
Accounting	Posting as expenses	Posting as expenses	Posting as expenses	Posting as expenses	Posting as expenses	Posting as expenses
Taxation	Generally, exclusion in expenses	Generally inclusion in expenses	Generally inclusion in expenses	Generally, exclusion in expenses However, individual allowance acceptable	Generally, exclusion in expenses	
Allowance for bad debt						
Accounting	General and individual allowance	General and individual allowance	General and individual allowance	General and individual allowance	General and individual allowance	General and individual allowance
Taxation	General and individual allowance	General and individual allowance	General and individual allowance	Only individual allowance	Only individual allowance	
Depreciation						
Accounting	Fixed amount method, Fixed rate method, and others	Fixed amount method, Fixed rate method, and others (Fixed amount method in principle, Fixed rate method partially)	Fixed amount method, Fixed rate method, and others (Fixed amount method in principle, Fixed rate method partially)	Fixed amount method, Fixed rate method, and others (Generally fixed amount method)	Fixed amount method, Fixed rate method, and others (Generally fixed amount method)	Fixed amount method, Fixed rate method, and others
Taxation	Inclusion in expenses	Inclusion in expenses	Inclusion in expenses	Separately calculated in tax (fixed rate method)	Separately calculated in tax (fixed rate method)	
Impairments						
Accounting	Based on consolidated assets, estimating and writing down future cash flows	Applying lower of cost or market method to individual assets	Based on consolidated assets, estimating and writing down future cash flows	Based on consolidated assets, estimating and writing down future cash flows	Based on consolidated assets, estimating and writing down future cash flows	Based on consolidated assets, estimating and writing down future cash flows
Taxation	Exclusion in expenses	Inclusion in expenses	Exclusion in expenses But under consideration	Exclusion in expenses	Exclusion in expenses	

	Japan	Germany	France	U.K.	U.S.	IAS/IFRS (Reference)
Finance lease transactions without title transfer						
Accounting	Selling and buying treatment in principle Lease treatment acceptable exceptionally	Selling and buying treatment Lease treatment in case of fulfilling numerical standards (Note 2)	Lease treatment	Selling and buying treatment	Selling and buying treatment	Selling and buying treatment
Taxation	Lease treatment However, Selling and buying treatment if inconvenient in taxation	Selling and buying treatment Lease treatment in case of fulfilling numerical standards (Note 2)	Lease treatment	Lease treatment However, Selling and buying treatment acceptable without inconvenience in taxation	Selling and buying treatment Lease treatment in case of fulfilling numerical standards (Note 3)	
Evaluation						
Accounting	Securities for sale: market value method Held-to-maturity security: amortized cost method Other securities: market value method (directly included in capital)	Cost or market method	Cost or market method (allowance for depreciation)	Cost or market method in principle Market value method for securities for sale	Securities for sale: market value method Held-to-maturity security: amortized cost method Available-for-sale securities: market value method (Other comprehensive income)	Securities for sale: market value method Held-to-maturity security: amortized cost method Available-for-sale securities: market value method (included directly in capital, through statements on fluctuation in shareholders' equity)
Taxation	Securities for sale: market value method Held-to-maturity security: amortized cost method Other securities: cost method	Inclusion in expenses, only in case of long-term fall in prices	Inclusion in expenses	Securities for sale: market value method Others: Cost or market method	Cost method, in principle Market value method selectable Only for securities held by trader on business purposes	
Derivative						
Accounting	Recognizing at making contracts, and evaluating at fair value	Recognizing at settlement	Recognizing at making contracts, and evaluating at fair value; or allowance for depreciation	Recognizing at settlement, however it shall be recognizing at making contracts from 2006 (selectable for 2005)	Recognizing at making contracts, and evaluating at fair value	Recognizing at making contracts, and evaluating at fair value
Taxation	Appraisal loss and gain included in expense or income	Not applicable	Appraisal loss and gain included in expense or income (Note 4)	Not applicable	Different depending on kinds of derivatives (Note 5)	

	Japan	Germany	France	U.K.	U.S.	IAS/IFRS (Reference)
Stock Opti						
Accounting	Not posting as expenses (under consideration for posting as expenses (Note 6))	Not posting as expenses	Not posting as expenses	Posting as expenses (Note 7)	Posting as expenses (Note 8)	Posting as expenses
Taxation				Exclusion in expenses	Exclusion in expenses However, if unqualified in tax system (tax on beneficiary), original value at execution included in expenses	

(Note 1) Discount rate is regulated at 6% in tax, and applicable in accounting.

(Note 2) Only when lease period exceeds 90% of useful life of assets, selling and buying treatment is conducted. The scope of selling and buying is very narrow.

(Note 3) 1) The ratio that lender invests into lease assets is 20% or less.

2) Lease period is 80% or over of estimated useful lifetime.

3) The residue value at the end of lease is 20% or less of acquisition costs.

If any cases lease falls into, selling and buying treatment is carried out. Therefore, the scope of selling and buying treatment is different from accounting.

(Note 4) Only potential income (appraisal income) of relative transactions is not considered on calculation of taxable income.

(Note 5) Evaluation of derivatives at fair value is applied to future contract and non-equity option with future contract as underlying asset, but not to swap contracts and equity-type option, in principle.

(Note 6) In December 2004, ASBJ published "Accounting standards on stock options and others (draft)" to force to post as expenses. It is under consideration (expected to disclose on and after April 1, 2006, and apply from the business starting year).

(Note 7) FRS No.20 "Stock compensation" similar to IFRS No.2 "Stock compensation" will be applied to listed companies from 2005, and to unlisted companies from 2006.

(Note 8) Amendment of SFAS No. 123 "Stock compensation" forcing to post as expenses will be applied from June 15, 2005, at start of the second quarters. However, it is possible to apply it from the next business year.

IAS/IFRS Implementation in 2005, Revision of Domestic Laws, and Trends in Practices in the EU

1. Scope of IAS/IFRS Application by IAS Law (Regulation (EC) No. 1606/2002)

	Consolidated financial statements	Individual financial statements
Listed companies	Mandatory application of IAS/IFRS (Article 4)	Each country choosing whether forcing or just accepting IAS/IFRS (Article 5)
Other companies	Each country choosing whether forcing or just accepting IAS/IFRS (Article 5)	Each country choosing whether forcing or just accepting IAS/IFRS (Article 5)

2. IAS/IFRS Application to individual financial statements in Germany, France, and U.K.

Regarding Article 5 of IAS Law, Germany, France, and U.K. will not force IAS/IFRS, but differently correspond to acceptance of IAS/IFRS.

	Germany	France	U.K.
Trend in revision of domestic law	Acceptance of bill	Under deliberation of CNC	Acceptance of bill
Individual financial statements of listed companies	While accepting IAS/IFRS, also obligating preparation of individual financial statements based on German standards for taxation.	Deciding whether accepting IAS/IFRS or not, after considering impacts on tax and commercial law due to introduction. Under existing law, IAS/IFRS individual financial statements not acceptable for outside report	Accepting IAS/IFRS Usable for taxation and calculation of amount available for dividends
Consolidated financial statements of unlisted companies	Accepting IAS/IFRS	Accepting IAS/IFRS	Accepting IAS/IFRS
Individual financial statements of unlisted companies	As for large companies, how to deal with is same as listed companies (Note)	Same way to handle as listed companies	Same way to handle as listed companies
Practical trend	Preparing individual financial statements based on German standards, and using IAS/IFRS at preparing consolidated financial statements	Preparing individual financial statements based on French standards, and using IAS/IFRS at preparing consolidated financial statements	While unification to IAS/IFRS possible (never preparing statements based on U.K. standards), expected to judge in consideration of impact on tax, costs to shift to IAS/IFRS, and impact on capability to pay dividend.

(Note) Special regulation on middle and small-sized companies has not been set up yet, regarding IAS law.

Approaches to Convergence and Reform of Accounting Systems in Germany, France, and the U.K.

	Germany	France	U.K.
Existing activity for convergence (Note)	Accepted IAS and USGAAP at consolidation level especially	Set up consolidation standard for convergence to IAS/IFRS	Convergence to IAS/IFRS without separating consolidation and individual
Positioning of individual financial statements (in direction of separating consolidation and individual)	Convergence to IAS/IFRS not advance at individual level Decided to disclose individual financial statements based on IAS/IFRS on a voluntary basis, maintaining protection of creditors, and individual financial statements based on German commercial law for dividend calculation for the time being.	Having convergence project to IAS/IFRS at individual level, and convergence in depreciation, accounting for impairments, and allowance completed. (Differences partly left even with revised standards) Having many problems on financial instruments, lease accounting, accounting for retirement benefit in future.	Planning convergence to IAS/IFRS in short term, at individual level
Direction of tax accounting	Principle of standards of commercial law to tax law is almost collapsing. According to the survey by governmental experts, the opinion to support taxable calculation separated from settlement on commercial law is dominant.	Considering adjustment with taxation along with the introduction of IAS/IFRS to individual financial statements in "IAS and Tax" project. Loosing touch with tax law gradually, without acceptance of accounting for impairments	Convergence advancing with accepting financial statements prepared based on IAS/IFRS
Activity for accounting for small and middle-sized companies	Applying standards of German commercial law, presently	Applying standards of French commercial law, presently In "IAS and Tax" project, application of simplified accounting standards under consideration	Applying simplified "finance reporting standards (FRSSE) for small-sized companies"

(Note) As for existing activities for convergence, the situation before applying IAS law is indicated. After applying IAS law, there will be possibility to separate consolidation and individual in many EU listed companies even temporarily. (See Appendix 5 "IAS/IFRS Application in 2005 and Revision of Domestic Laws, and Practical Trend in EU")