

## **Summary of Report on the Internationalization of Business Accounting in Japan**

### **. Background**

As corporate activities have grown increasingly international, and international commonality is sought in business accounting, the challenge that faces the internationalization of business accounting is the question of how to integrate accounting standards that are deeply rooted in individual countries. Japan is no exception. This report summarizes the basic philosophy regarding the internationalization of business accounting in Japan, such as the equivalency of Japan's accounting standards and the IFRS, based on the concept of mutual acceptance and through the verification of accounting standards and a unified position on the international convergence of business accounting.

### **. Contents of the Report**

#### **1. Effecting Mutual Acceptance**

In order to act in ways that would not hinder the fund raising and other global activities of corporations, while recognizing the individuality of the accounting standards of individual countries, "mutual acceptance" should be sought; countries would mutually recognize one another's accounting standards only if they were "equivalent." As long as individual standard items that are indispensable to investors and others are clearly stipulated in an explainable format, and the standards are comparable in terms of their usefulness and comparability, these standards should be deemed to be equivalent.

An EU directive requires corporations based outside of the EU that have their securities listed in the European markets to use "the IFRS or other standards that are deemed to be equivalent to the IFRS" in their financial statements for continuing disclosure in the EU market or new listings of their securities in the EU market. Should it be judged that Japan's accounting standards are not equivalent to the IFRS and that disclosures made in compliance with Japanese accounting standards are not accepted by the EU, we have serious concerns about the potential direct impact on fund raising by these Japanese securities issuers in the EU.

Action was initiated in Japan in 1998 to achieve international harmonization and improve accounting standards at a rapid pace by taking into consideration the IFRS and U.S. accounting standards. These changes (termed the "Accounting Big Bang") were Review of the Scope of Consolidation, Deferred Tax Assets and Liabilities (Tax Effect Accounting), Accounting for Retirement Benefits, Accounting for Financial Instruments, Accounting for Impairments etc.

This Study Group made a comparison of Japanese accounting standards, and the IFRS and U.S. accounting standards with respect to 23 major accounting standard items, including financial statement presentation, retirement benefit accounting, financial instruments and impairment accounting. (The comparison was made at the

end of March 2004, when major IFRS items were presented. ) Some are as follows:

(i) Accounting for Financial Instruments

The IFRS also classify marketable securities that are held for trading as financial assets whose value is measured at fair value through the income statement. Other marketable securities are treated as available-for-sale financial assets and measured at fair value. Fluctuations in their value are noted directly in the equity section through the statement of changes in equity. The IFRS is thus fundamentally the same as Japanese accounting standards.

( ) Accounting for Impairments

With respect to the standards for recognizing impairment losses of fixed assets, Japanese accounting standards, as well as U.S. accounting standards, use undiscounted cash flows as the basis, whereas the IFRS uses the recoverable amount as the basis. Regarding the standards for measurement of impairment losses, however, both Japanese accounting standards and the IFRS use the recoverable amount. Therefore, no significant difference exists between the two.

( ) Accounting for Business Combinations

The IFRS permits only the purchase method of accounting for business combinations. It does not permit the pooling of interest method. Under the Japanese accounting standards, the pooling of the interest method is permitted under certain extremely specific conditions in consideration of the international trends in accounting standards. This is a reflection of the economic reality of Japan, where major on an equal footing is widely practiced as a mode of business combination, and should help improve, rather than harm, the reliability of financial statements.

Based on the foregoing analysis and accounting practice, and after listening to the opinions of not only the Japanese investors and other market participants but also European and American corporations and investors in Japan, this Study Group concludes that the Japanese accounting standards are at a level that compares well with the IFRS and thus are equivalent to the IFRS when judged by such criteria as usefulness, comparability, reliability and transparency, even though there are some small technical differences between the two sets of standards.

## 2. Resolution of the Legend Issue

The “legend” refers to a statement that is included in the footnotes to financial statements that are prepared in accordance with Japanese accounting standards, and informs readers that “the statements do not present the financial condition, operating

results or cash flows that were prepared in accordance with accounting principles and practice that are generally accepted in countries other than Japan.”

In Japan, international harmonization of accounting standards has been promoted rapidly through the Accounting Big Bang. At this stage, we believe that the Japanese accounting standards are at a level that compares well with the accounting standards of European and American countries.

This Study Group will urge European and American audit firms to eliminate the legend affixation through Japanese audit firms.

### 3. International Convergence: Efforts and Obstacles

International convergence of business accounting is a long-range goal beyond the intermediate goal of mutual acceptance. Even if national accounting standards may be equivalent today, it is undoubtedly more desirable to bring different national accounting standards close together to achieve international convergence, and move in the direction of setting a single set of high-quality accounting standards.

Such international convergence would ensure the usefulness and comparability of financial statements, and help the Japanese capital market to grow without being isolated internationally. Furthermore, it would promote mutual investments on an international scale.

The direction that should be pursued is one in which the accounting standards of Japan, the United States and Europe are steadily meshed so that the opinions of market participants, such as investors and corporations, are fully reflected. Such work should in turn accelerate the convergence, and win the support and endorsement of market participants for the international convergence and integration of business accounting standards over the long run.

Japan therefore believes that sufficient debate among all parties involved, including market participants, and consensus formation are necessary in this endeavor, and that we should work toward this long-term goal while sharing our views with the United States and Europe as we proceed with our task.

The major issues such as Performance Reporting (Comprehensive Income : a change in net assets during the period (excluding transactions with shareholders)) for the future, which are currently being debated by the IASB, pose obstacles to international convergence. Japan is gravely concerned about these issues, as specific concepts seem to run ahead without reflecting the opinions of market participants, such as investors and corporations, being fully incorporated. Looking ahead, adequate discussions that involve market participants, including investors and corporations, are called for, together with formation of a consensus.