

# Features and Problems of Bank Accounting System in Japan

AKIO KURODA, MASATAKA KOTANI, and MARIE OGAWA

*This paper discusses the features and problems of the Japanese accounting system including related aspects of the tax system, focusing on accounting rules and practices with respect to banks.*

*The Japanese accounting system is based on three closely interrelated legal structures consisting of the Commercial Code, the Securities and Exchange Law, and various tax laws. In recent years, there has been a growing call for review and for establishment of a new framework but which still enables the original aims of each, namely the calculation of profit available for dividends under the Commercial Code, disclosure under the Securities and Exchange Law, and calculation of taxable income under various income tax laws, to be fulfilled.*

*Specific issues concerning the Japanese accounting system include: the introduction of market value accounting (MVA) principles, the amendment of accounting practices to take account of off-balance-sheet transactions, the expansion of the scope of disclosure, review of consolidated accounting standards, improvement of the credit loss allowance system and the international harmonization of accounting and tax systems. This paper will take up each one of these and examine possible future directions.*

## I. Introduction

This paper has been written for foreign scholars of accounting, accountants, financial regulatory authorities, members of financial institutions, and rating analysts with an interest in bank accounting in Japan. The paper aims to present a systematic description of the features and problems, including related aspects of the tax system, with focus on accounting principles and practices as applied to banks.

As the presence of Japanese banks and other financial institutions has increased in international financial markets in recent years, the criticism is often heard that the financial conditions of Japanese banks remain difficult to grasp. Coming into the 1990s,

---

This is a discussion paper and the views expressed are those of the authors and do not reflect those of Bank of Japan. The original paper, written in Japanese, was prepared for the monetary conference (*Kinyu-Kenkyukai*) held by the Institute for Monetary and Economic Studies, Bnk of Japan, in April 1993.

there has been considerable concern voiced regarding the soundness of Japanese banks amid the rapid increase in impaired loans which have become a burden for these institutions following the collapse of the so-called bubble phenomenon in asset markets. One of the basic contributory factors to such criticism is that it is not easy for foreign parties to understand the financial statements of Japanese banks, i.e. Japanese accounting as applied to banks and other enterprises in general, differs considerably in several respects from that in other major countries. Therefore, we believe it imperative to accurately describe Japanese accounting system. However, the main purpose of this paper is not to provide a detailed presentation; rather, its purpose is to clarify the conceptual framework of the accounting system and to explain the implications of specific problems.

There has been a marked increase in general interest in accounting issues in Japan in recent years. At the domestic level, this interest reflects the growing need to gain a better understanding of the financial conditions of banks and other enterprises which has been stimulated by the collapse of the bubble phenomenon at the beginning of the 1990s. At the international level, progress toward the formulation of International Accounting Standards (IAS) has gradually led to a clearer awareness of the differences between IAS and Japanese accounting standards. Such growing domestic and international concern has revealed that Japanese accounting system does not result in a complete reflection of the financial conditions of banks and other enterprises. Similarly, it has become clearer that harmonization with IAS will not be easy. This paper identifies and examines these issues. However, it should be noted that such examination is in its infancy, and that it will be necessary for standard-setting organizations or other concerned parties to undertake a lot of work and discussion before solutions are found.

This paper is structured as follows: Section II presents the framework of the current system and outlines features with respect to banks. The Japanese accounting system is based on three closely interrelated legal structures consisting of the Commercial Code (*Shou-hou*), the Securities and Exchange Law (*Shouken-torihiki-hou*), and various tax laws (*zei-hou*). In recent years, there has been a growing call for review and the establishment of a new framework but which still enables the original aims of each, namely the calculation of profit available for dividends under the Commercial Code, disclosure under the Securities and Exchange Law, and calculation of taxable income under various income tax laws, to be fulfilled. These issues are particularly conspicuous in the area of accounting practices for banks and these practices need to be reviewed immediately.

Section III is given to the review of specific issues related to Japanese accounting system. In Subsection A, the problems of the current system of historical cost accounting (HCA) are identified and adoption of market value accounting (MVA) rules in one form or another, particularly in the area of accounting of financial instruments, is argued. This is followed by an examination of the advantages and disadvantages of asset revaluation, with emphasis on real estate. Subsection B shows that current accounting standards for various off-balance-sheet transactions are inconsistent with each other. It is desirable to

formulate a unified accounting standard for off-balance-sheet transactions based on MVA rules, in order to grasp profit and loss accruing from off-balance-sheet transactions. In Subsection C, current disclosure rules for Japanese banks are described, and it is argued that the scope of disclosure must be expanded so as to increase transparency of bank management and to augment market discipline. Subsection D discusses current standards for consolidated accounting, and shows that scope is limited by application of the "principle of materiality." It is suggested that standards be reviewed to extend the scope of consolidation so that a more comprehensive picture of the financial conditions of the enterprise group can be gained. Subsection E compares Japanese rules for credit loss allowances with those of other major countries and identifies differences such as tax treatment and the need for official approval of tax and banking supervisory authorities. It is argued that current practices be amended so that credit loss allowances can fulfill their original role. Subsection F deals with the importance of the harmonization of accounting standards. However, it is thought that this will not be easy because Japanese accounting standards are unique in various respects such as asset valuation, disclosure, and consolidated accounting, compared with those of other major countries and IAS. Finally, national sovereignty and difference in taxation concepts compound the difficulty.

## II. The Current Accounting System

### A. Outline

#### 1. *Legal framework: interrelation between the Commercial Code, the Securities and Exchange Law, and tax laws*

The Commercial Code, the Securities and Exchange Law, and various tax laws provide the legal framework for Japanese business accounting system. The Financial Accounting Principles for Business Enterprises (*Kigyo-kaikei-gensoku*) works as a supplement to provisions of these laws. The Business Accounting Deliberation Council, an advisory body to the Minister of Finance, is charged with formulating accounting standards that furnish useful information for investors under the Securities and Exchange Law. The Council has also made important contributions to the establishment of accounting standards under the Commercial Code and tax laws (Arai and Shiratori (1992)).

The primary purposes of business accounting are: (i) to disclose management's performance of its stewardship functions; (ii) to calculate the distributable income, i.e. the profit available for distribution and taxable income; and (iii) to provide information needed for making investment decisions. However, reflecting its diversity of parties concerned and statutory objectives (Table 1), the above-mentioned legal basis contains different standards for the formulation of accounting rules.

For instance, the Commercial Code assumes that the interested parties are (i) shareholders who are concerned about dividend payments and fluctuations in stock

Table 1  
Legal Framework of Japan's Accounting System

Applicable Law	Interested Parties	Statutory Objectives
Commercial Code	Shareholders, investors, creditors	Calculation of profits available for distribution; provision of sufficient information to interested parties
Securities and Exchange Law	Shareholders, investors	Disclosure of information of companies (whose shares are traded) for investor decision making
Income tax laws	National and local governments (tax collectors), residents (tax payers)	To impose tax justly and fairly in accordance with taxpayers' ability to pay

prices, (ii) investors who are planning to make investments based on expected price earnings ratios (PER), (iii) creditors, including bondholders and (iv) potential creditors who intend to make loans or purchase corporate bonds. Its main statutory objectives are (i) to stipulate appropriate methods to calculate the profit available for distribution so as to balance the interests between current and future shareholders, as well as between shareholders and creditors and (ii) to provide sufficient information pertinent to the interests of current and future shareholders or investors, as well as current and future potential creditors.

The Securities and Exchange Law assumes that the interested parties are shareholders and investors and its statutory objective is to make companies (whose shares are publicly traded) disclose information necessary to enable investors and shareholders to make decisions.

Income tax laws assume that the interested parties are tax authorities of national and local governments as tax collectors, and residents, as taxpayers. Here the statutory objective is to impose tax justly and fairly in accordance with taxpayers' ability to pay.

As indicated, the Japanese accounting system is based on the Commercial Code, the Securities and Exchange Law, and tax laws, all of which have different statutory objectives. Nevertheless, the actual accounting standards based on each are interrelated and closely tied together. Because of interrelation and close tie among three different statutory objectives, the Japanese accounting system is often called a "Triangular System."

The relationship can be described as follows. Tax laws are based on the "principle of approved financial statements." Thus, corporate taxable income is calculated based on income reported in financial statements under the Commercial Code and which are approved at a general meeting of shareholders, i.e. taxes are based on profits as defined by Commercial Code accounting. On the other hand, tax laws often contain detailed provisions concerning the calculation of profits and losses to assure fairness, so that the

calculation of profits under the Commercial Code depend, to a significant extent, on income tax law standards. For instance, accounting standards under the Commercial Code and the Securities and Exchange Law for such items as credit loss allowances, the fiscal year assignment of revenues and expenses arising from long-term construction, determination of depreciation period, and detailed stipulations for the valuation of securities, are established based on provisions under tax laws. Besides, it is generally viewed that Rules Governing Financial Statements (*Zaimu-shohyo-kisoku*) applied to the annual securities report prepared by all listed companies (under the Securities and Exchange Law) conforms to stipulations of the Commercial Code and tax laws, and as such, does not fulfill the original statutory objective of providing decision-making information to investors to satisfy user needs.

## **2. Possibility of separating financial accounting and tax accounting**

Business accounting provides ex post identification of changes in financial position resulting from business activities, and is a basis for calculating of taxable income. On the other hand, business accounting standards influence the behavior of corporations and banks in many ways. For this reason, and particularly in the case of Japan, any change in accounting principles affecting corporate profits and the tax base cannot be easily implemented. The implementation is usually very slow because it is difficult to adjust the conflicting interests of interested parties to reach a consensus.

This situation may be said to have been brought about by putting too much emphasis on the compatibility and interrelation of different statutory objectives. Thus, it may be worthwhile to look at the basics and consider the possibility of separately applying different accounting standards for different objectives. This is to say, we may prefer to consider making a clear separation between financial accounting under the Commercial Code and the Securities and Exchange Law and tax accounting under tax laws, as well as apply different sets of rules to ascertain profits available for distribution under the Commercial Code, the disclosure of business activity under the Securities and Exchange Law, and calculation of the tax base by tax laws in accordance with the original statutory objectives of respective laws. The separation of respective accounting standards may very well lead to the relatively easy resolution and improvement of many of the problems which will be discussed later in this paper.

For instance, it would be possible to aim at greater disclosure under the Securities and Exchange Law by making greater use of market value accounting (MVA) rules in the valuation of assets. Likewise, unrealized profits from off-balance-sheet transactions which are not subject to taxation under tax laws could be partially included in the calculation of profits available for distribution under the Commercial Code. Moreover, it would become possible to maintain accounting system compatibility between Japan and other industrialized countries which are not based on three interrelated legal structures and where multiple accounting statements are commonly required.

The separation of accounting standards, however, would require the preparation of multiple accounting statements by corporations, leading to a heavier workload. This would be a critical issue for smaller enterprises which lack accounting experts. Taking feasibility into consideration, therefore, one option may be to begin with the larger corporations which have adequate human resources and exercise a major influence on society.

## **B. Features of the Bank Accounting System**

### **1. Legal framework**

In Japan, banks are stock companies incorporated under the Commercial Code and hence provision for accounting of the Code also applies to them. Also, banks are subject to the Securities and Exchange Law and various tax laws unless these laws are inconsistent with the Banking law. With regard to items to be recorded and methods of recording, the enforcement regulations of the Banking Law hold precedence over Rules of Accounting Statements (*Keisan-shorui-kisoku*) and Rules Governing Financial Statements (*Zaimu-shohyo-kisoku*), under Article 3 of the Ministerial Ordinance Regarding Exceptions to the Rules of Accounting Statements and Article 2 of the Rules Governing Financial Statements. Furthermore, details of the Bank Accounting Standards (*Kessankeiri-kijun*) are prescribed in an administrative circular of the Ministry of Finance (Circular No. 901 of the Banking Bureau of the Ministry of Finance dated April 1, 1982, "Circular of the Director of the Banking Bureau Regarding Basic Matters Related to the Business Operations of Banks").

Before 1967, emphasis was placed on sound accounting practices based on conservative and cash-basis principles. In addition, under the pre-1967 system, an evening-out of announced profits was practiced. After 1967, bank accounting standards were established according to the general business accounting standards on such aspects as accrual basis accounting for revenues and expenses, while amending them in several points because of the need to supervise banks in view of their social responsibility and public accountability.

The main differences which exist between general business and bank accounting standards include: (i) in the case of the write-offs of bad loans against allowances, banks must also receive approval from an inspector of the Banking Bureau of the Ministry of Finance, while ordinary corporations are merely required approval from the tax authorities; (ii) with regard to valuation standards for listed securities, banks must apply "the lower of cost or market (LCM)" to all securities on trading accounts, and to stocks and convertible bonds on investment accounts, while ordinary corporations can choose between historical cost accounting (HCA) and LCM; (iii) all personal and real property newly acquired in place of present assets by banks for operational purposes must be entered at reduced values, while ordinary corporations can object against reduced-value

entry even when possible; (iv) in the case of banks, the depreciation of real property is fixed at 60% higher than tax standards for ordinary corporations; and (v) banks are obliged to make appropriations to various allowances and reserves, such as the allowance for credit losses, which ordinary corporations do not.

## **2. Review of bank accounting standards**

The various problems concerning Japanese accounting will be discussed under Section III, but are more conspicuous in bank accounting. Moreover, it is essential that bank accounting standards provide a complete reflection of a bank's financial conditions, because the general public (including corporations) constitute the majority of a bank's creditors as depositors, and because their access to a bank's true financial conditions is intimately connected with the maintenance of stability in the overall financial system. Appropriate bank accounting standards are an equally important prerequisite for the regulatory authorities who must inspect, examine, and monitor banks to gain an accurate grasp of bank conditions and to provide suitable guidance measures. Furthermore, as the progress of internationalization of finance has raised the levels of activity of Japanese banks in international financial markets in recent years, there has been increasing international demand for greater transparency and comparability in Japanese bank accounting.

Based on the foregoing considerations, it can be seen that while adjustments in general business accounting standards are required, there is urgent need to commence review of bank accounting standards as soon as possible.

Taking into account the fact that, as discussed above, bank accounting standards are based on the enforcement regulations of the Banking Law, it is possible to improve them by amending the regulations of the Banking Law and ministerial circulars. However, should this procedural approach be taken, there is the danger that bank accounting standards become even more difficult to comprehend, perhaps giving rise to general feelings of suspicion regarding bank accounting standards. In order to avoid this, it is necessary to comply with due process and to build a broadly-based consensus through open discussion.

Along with the progress of financial liberalization in recent years, non-financial corporations are increasingly participating in financial transactions. Should there be any differences in the handling of financial transactions between general business and bank accounting standards, it would undermine the equitable treatment of banks and non-financial corporations, or might give rise to disparities in costs and benefits of transactions. In turn, there is the risk that such differences will affect the efficiency and stability of financial transactions and obstruct the development of financial markets. As such, due attention must at least be paid to maintaining consistent treatment for similar financial transactions under general business and bank accounting standards.

### III. Problems in Japanese Accounting System and Proposed Improvements

#### A. Introduction of Market Value Accounting (MVA)

##### 1. *Current asset valuation standards and problems*

###### *The current situation in Japan*

In principle, asset valuation in Japan is based on historical cost accounting (HCA) as defined by the cost of acquisition including acquisition expenses as prescribed by the Commercial Code. The objective of this approach is to enforce a rational distribution of costs to prevent arbitrary valuation, and to prohibit the appropriation of unrealized profits in order to maintain sound accounting practices. Under this system, when there is a significant decline in market or effective prices (excluding cases in which a recovery in market prices can be surely expected), assets must be devalued to reflect market prices or by significant amounts. As an alternative, current assets and publicly listed corporate bonds and shares (excluding shares of subsidiary companies) are subject to “the lower of cost or market (LCM).”

The above valuation standards generally apply to bank accounting standards. However, the following rules apply to the valuation of securities in accordance with the Bank Accounting Standards (Table 2). LCM is applied to listed securities on trading accounts; banks are able to choose either HCA or LCM for unlisted securities on trading accounts. With regard to securities on investment accounts, for publicly listed government bonds and other bonds (excluding convertible bonds), banks are able to choose either HCA or LCM accounting. However, all listed shares (excluding shares of subsidiaries) and convertible bonds must be valued on LCM basis, while shares of subsidiaries and unlisted securities must be valued at historical cost.

###### *Problems of Historical Cost Accounting (HCA)*

As discussed, the Japanese accounting system, while making partial allowances for LCM, is generally based on HCA, resulting in significant disparities in book and market values, in recent years giving rise to the following problems.

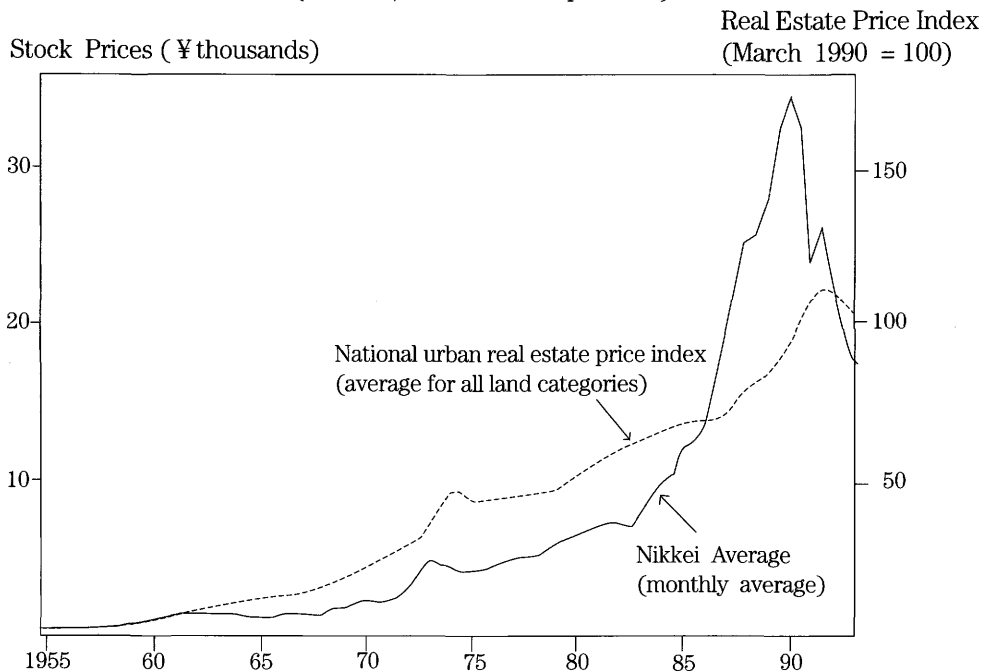
- (i) As shown in Figure, the prices of stocks and real estate in Japan have risen very significantly over the long term, resulting in a great disparity in the book and market values of real estate and stocks owned by older and well-established companies. This implies that these companies are carrying huge amounts of unrealized profits which do not appear on their books.
- (ii) Because securities are valued at either HCA or LCM, profit levels can be raised through the realization of hidden profits.
- (iii) On the other hand, companies may hide valuation losses by adjusting prices via back-to-back securities transactions. For instance, a company may sell listed secur-



Table 2  
Securities Valuation Standards of Banks

Category		Valuation Standard	
Securities on trading accounts	Listed on exchange	Lower of cost or market	
	Others	Historical cost, or lower of cost or market	
Securities on investment accounts	Listed on exchange excluding shares of subsidiaries	Government bonds and other bonds	Historical cost, or lower of cost or market
		Other securities such as stocks, convertible bonds	Lower of cost or market
	Shares of subsidiaries	Historical cost	
	All other securities	Historical cost	

Figure Trends in Stock and Real Estate Prices  
(1995-92, March and September)



Source : National urban real estate price index: The Japan Real Estate Institute

Nikkei Average: Nihon Keizzai Shimbun Inc.

ities, which are subject to disclosure at market price or be reported on LCM basis, at a price above the market price (such as at book value) and buy unlisted securities at a price above current prices. Through such a transaction, unlisted securities which have suffered substantial valuation losses can be kept on the books without being devalued to hide a deterioration in asset content.

Given the current status of the Japanese accounting system, the financial conditions of a company may not be accurately reflected in its balance sheets. As a result, creditors are unable to judge whether corporate assets have been undermined, while shareholders and investors may either overestimate or underestimate the true strength of a company. These factors may also lead banks and other companies to engage in manipulation aimed at upgrading or downgrading the appearance of their financial statements.

## **2. Revaluating historical cost accounting (HCA) and weighing the introduction of market value accounting (MVA)**

### *Revaluating Historical Cost Accounting (HCA)*

In the 1962 amendment of the Commercial Code, the previous below-market-price (BMP) accounting system, by which assets listed on balance sheets are valued at below market price, was replaced with HCA for the following reasons: (i) from the perspective of the “earnings and expenses approach,”<sup>1</sup> HCA was believed to be a more desirable standard because it allowed more accurate calculation of profits and losses accruing in a given term; (ii) it removed arbitrary valuation and was more amenable to verification; and (iii) it contributed to sound accounting practices by prohibiting the appropriation of unrealized profits.

However, the above arguments in favor of HCA are subject to the following criticisms. With regard to (i), the current accounting system under the Commercial Code is not based purely on a “earnings and expenses approach.” LCM is applied to the valuation of certain assets, and MVA are enforced in other cases. Thus, the current system retains elements of the “capital approach” and does not negate the introduction of other valuation standards which can contribute to an increase in accounting information. Regarding (ii), it cannot be denied that HCA is superior in the sense of being objective and verifiable. However, there is no inescapable reason why assets which can be objectively valued in the market must be subject to HCA. Similarly, it is not impossible to formulate objective measures of value other than HCA. With respect to (iii), the prohibition of the appropriation of unrealized profits was initially based on the belief that it was desirable to prevent the outflow of valuation profits in the form of dividends and taxes.

---

<sup>1</sup>The “earnings and expenses approach” calculates profits and losses accruing in a given term on the basis of earnings and expenses registered in formal transaction records. This approach is readily adoptable for HCA. On the other hand, the calculation of profits and losses based on changes in capital at the beginning and end of the term is referred to as the “capital approach.”

However, in the case of financial assets and other assets which can be readily liquidated, there is some doubt as to whether it is appropriate to retain a sharp distinction between unrealized and realized profits. Another related problem is that when a company has hidden losses, it may pay out dividends in excess of its actual capacity.

#### *Advantages and disadvantages of Market Value Accounting (MVA)*

Advantages: (i) creditors, shareholders and investors are able to more accurately estimate corporate asset values, and decision-making on the basis of self-accountability is facilitated; (ii) because corporate asset values are more accurately estimated and disclosed, managers will work to achieve greater management effectiveness and transparency; and (iii) companies will be restrained from making arbitrary adjustments in apparent profit levels by choosing an advantageous time to realize hidden profits and losses. The restraining of profit manipulation will allow the correction of distortions in market transactions referred to above.

On the other hand, MVA has the following disadvantages: (i) as a practical problem, the determination of market values is not easy and entails certain costs; and (ii) compared to HCA, profit levels may be subject to greater fluctuations in the short run. In such cases, interested parties may be misled by the accounting information which becomes available at a point in time.

#### *Accounting of unrealized holding gains and losses*

Should MVA be adopted in Japan, this would entail certain changes in current HCA rules and give rise to the problem of how to deal with unrealized holding gains and losses, which do not appear in the financial statements under the current accounting system.

The question is whether unrealized holding gains and losses should be counted in profits available for distribution. From the perspective that MVA more accurately reflects the true corporate position, the answer may be affirmative. However, given that market values are mere measurements a more dominant view is that it is undesirable to allow all unrealized holding gains to flow out in the form of dividends.

In considering whether unrealized gains should be allowed to be counted as available for distribution, a crucial factor will be whether the assets in question—for instance, marketable securities—can be readily liquidated or not. The situation is somewhat different in the case of holding losses. Insofar as these represent a real devaluation in asset values, it is appropriate to include them in calculating profits from the perspective of maintaining the soundness of corporate assets. Moreover, it is possible to have double reporting of profits consisting of current “profits available for distribution” and a new entry, such as “profits including unrealized holding gains and losses.” The question of the inclusion of unrealized holding gains and losses in the calculation of taxable profits can be treated in the same way as that of profits available for distribution.

Given that the primary statutory objective of the Securities and Exchange Law is the provision of information to investors and that it does not contain any provisions for

asset/liability valuation standards, it would be possible to introduce MVA exclusively in Securities and Exchange Law accounting. This would give rise to disparities between profits disclosed to shareholders and investors under the Securities and Exchange Law, and profits available for distribution calculated under the Commercial Code or taxable profits calculated under income tax laws.

#### *Coverage of Market Value Accounting (MVA)*

It can be argued that, from the perspective of the disclosure of information to shareholders and investors, MVA should be applied to all assets/liabilities. However, the calculation of market values for certain types of assets/liabilities would be difficult. In addition, it may be more costly for corporations to adopt MVA. For these reasons, it is argued to be more appropriate to introduce MVA for assets/liabilities for which the undesirable effects of current HCA are particularly large. (The application of MVA to off-balance-sheet transactions will be discussed under B below.)

##### *a. Securities*

Valuation standards can be classified as follows: (i) MVA should be applied only to securities held for the short term; (ii) MVA should be applied to securities with high marketability; and (iii) MVA should be applied to all shares, except shares of subsidiaries to be valued by HCA.

With regard to the distinction based on intended length of holding period (i), while it is true that assets intended for long-term ownership do include cross held shares and other assets which little require MVA, this approach can be generally faulted for lacking objectivity. In addition, it is unlikely that the objective value of securities and their importance in the make-up of corporate assets are dependent on the purpose of ownership. Thus, there is reason to argue that this distinction is inappropriate. Furthermore, close attention must be paid to the fact that fluctuations in the value of investment securities held over the long term will affect the values of corporate assets.

The distinction based on marketability (ii) is widely supported, because in the case of securities with low marketability, it is not possible to ensure the market value objectivity, and such securities cannot be easily converted to cash. However, the question remains as to what is meant by low-marketability, which may be taken to merely denote unlisted securities or securities which are virtually inconvertible into cash—e.g. those in the quasi-public sector. Given this ambiguity, the crucial point will be whether or not it is possible to specify an objective standard to which all interested parties can agree.

Regarding (iii), there are several reasons for treating the holding shares of subsidiaries separately from other holdings. Because such shares are not normally expected to be sold, the appropriation of unrealized holding gains is undesirable. However, if it is preferable for a deterioration in the financial condition of a subsidiary to be reflected in the holdings of the parent, it would be desirable to either apply the equity method after having evaluated the assets of the subsidiary at market value, or to apply LCM accounting.

*b. Land*

For the following reasons, a dominant view is to reject the application of MVA to tangible fixed assets, in particular land which is non-depreciable: (i) it is difficult to make objective standards for MVA; (ii) because these assets are owned over the long term, the information of market values are less significant; and (iii) land utilized as an operating asset is significant only for its holding value and should not be assessed at market.

However, in recent years, there has been a growing view to accept the significance of MVA with respect to land and to assert that it is at least necessary to disclose information about its market value. Reasons for this position are: (i) objective standards for the market valuation of land are available, such as assessments by real estate assessors and land tax basis; (ii) the objective valuation of landholdings is significant because corporate assets valued at market prices more accurately reflect the corporate financial position, and because market valuation is directly related with a company's financing capabilities—i.e. in the absence of market valuation, investors will tend to overestimate or underestimate hidden profits; and (iii) for corporations, the value in use of holding land is not acquisition cost but closer to market value.

On the other hand, it is often argued that while the significant disparity between book and market values which exists today does pose a problem, land and other tangible fixed assets are more amenable to other modes of "asset revaluation" which will be discussed under (3) below. In this connection, various problems are cited regarding the application of MVA to such assets: (i) the significant burden of annual valuation; (ii) barring a rapid hike or decline in land prices, the need for annual valuation is not as much as for securities and other marketable assets; (iii) the inclusion of unrealized holding profits in the calculation of profits available for distribution is problematic, because these assets are not expected to be sold.

### **3. Examination of asset revaluation**

#### *Defining asset revaluation*

"Asset revaluation" refers to the accounting procedure of raising or reducing the book value of assets to reflect current values when significant disparities have developed between values assessed under historical cost accounting (HCA) principles and current market values. In postwar Japan, major asset revaluation programs have been undertaken on three occasions (Table 3). Asset revaluation was also considered during the 1970s in connection with the introduction of inflation accounting principles.

It should be noted, however, that all asset revaluations undertaken in Japan in the past were designed to make up for the shortfall in the depreciation of depreciable assets caused by inflation, and to strengthen corporate capital bases. As such, past revaluations were not really applied to land and other non-depreciable fixed assets.

As previously mentioned, the landholdings of Japanese companies are carried on

Table 3  
Summary of Asset Revaluation in Japan

First revaluation (1950)	-Voluntary revaluation under Asset Revaluation Law -Coverage: depreciable assets, real estate, stocks -Revaluation tax = 6% (installment and deferred payment permitted)
Second revaluation (1951)	-Voluntary revaluation under revised Law Concerning the Capitalization of Revaluation Reserve of Stock Companies -Coverage: depreciable assets, real estate -Revaluation tax = 6% (installment and deferred payment permitted)
Third revaluation (1953, 1954)	-Revaluation under revised Law Concerning Special Measures for Asset Revaluation for the Consolidation of Shareholder Equity (compulsory for some companies*) -Coverage: depreciable assets, real estate (compulsory only for depreciable assets) -Revaluation tax = 6% (installment and deferred payment permitted; commutative measures available for compulsory revaluations)

\*Under the Law concerning Special Cases of Asset Revaluation of Small and Medium-sized Companies enacted in 1957, revaluation was made compulsory for small and medium-sized companies which had not previously implemented a certain minimum revaluation.

their balance sheets at book value which grossly underestimates their market value. This tendency has grown in recent years with the result that balance sheets do not accurately reflect corporate financial positions. The introduction of market value accounting (MVA) would obviously constitute the most straightforward solution to these distortions. However, there is the view that it is preferable to maintain HCA while a revaluation of assets should be implemented in order to bring balance sheet figures closer to actuality.

Asset revaluation can be expected to have various effects. The financial information value of the balance sheet will be improved by correcting the underestimation of asset values and bringing these on-balance. This should improve the financial position of the company reported in its financial statements. Similarly, if revaluation surplus can be transferred to equity capital, this would contribute to higher capital adequacy ratios.

It will be necessary to thoroughly examine any asset revaluation program with regard to accounting and taxation issues, as will be discussed below, as well as from the perspective of setting standards for revaluation prices. However, should asset revaluation be implemented on a voluntary basis, it must be noted that this would not result in the immediate adjustment of the financial statements of all companies. If, in the interest of bringing corporate balance sheets closer to actual conditions, asset revaluation should be implemented on a continuous basis, instead of on a once-only basis, then this would burden companies with considerable costs.

*Issues related to the implementation of asset revaluation*

A wide range of issues must be thoroughly examined if Japan is to implement a new program of asset revaluation in the future. These include questions regarding accounting, taxation, and various necessary statutory adjustments as outlined below.

*a. Accounting procedure of revaluation surplus*

As in the past, revaluation surplus can be appropriated as revaluation reserves and credited to reserve funds in capital accounts. Based on a resolution of the board of directors of a company, revaluation reserves can be capitalized. Furthermore, bonus shares can be issued against this amount and distributed among shareholders, or it can be used to cover a portion of the value of the new issue (with the balance being paid by the shareholders who accept the allotment).

*b. Tax treatment of revaluation surplus*

As stated above, all past revaluation programs focused on the revaluation of depreciable assets. Therefore, to make up for the decrease in corporate taxes resulting from the increase in depreciation allowances, a revaluation tax of 6% was levied against revaluation surplus. However, in future revaluation programs, one possible approach is not to levy a tax on revaluation surplus. For one thing, according to Article 25 of the Corporate Income Tax Law, unrealized holding gains is not to be included as profits in the calculation of corporate income. Second, Land Value Tax has already been levied on the increase in asset values resulting from the rise in land prices. Third, if tax accounting book value is raised at the time of revaluation and a revaluation tax is paid, this could give rise to an inequitable outcome by creating significant differences in transfer tax on sales gains, depending on whether the asset is sold after revaluation, or whether it is sold without being revalued. Thus, a possible resolution could be; when revaluation is undertaken, financial accounting book value can be raised, while tax accounting book value remains unchanged and no revaluation surplus is registered. Later, when the land is sold, the difference between original book value and the sale value is registered under tax accounting as the profit on the sale, and taxes are paid on this amount. It should be noted that this procedure would require partial amendment to the current principle of approved financial statements.

*c. Statutory adjustments*

In order to undertake asset revaluation, book values, registered in accordance with HCA under the Commercial Code, must be amended. Therefore, various statutory adjustments of one type or another e.g. amendments to the Commercial Code, Asset Revaluation Law, and specific business laws must be made for changes in book values to be reflected in accounting forms and financial statements. If priority is to be given to ensuring greater disclosure, this can be done by introducing disclosure rules exclusively to accounting under the Securities and Exchange Law by making the necessary stipulations

in Rules Governing Financial Statements.

## B. Problems Related to Off-Balance-Sheet Transactions

### 1. Current situation of accounting standards and disclosure of off-balance-sheet transactions

#### Current situation

The volume of off-balance-sheet transactions has increased dramatically in recent years (Table 4) because: (i) transaction costs are lower than for on-balance-sheet transactions; (ii) recent technological innovation in financial markets and legal and tax-related deregulation have given rise to the development and proliferation of new financial instruments; and (iii) banks, the main players in off-balance-sheet activities, started emphasizing on return on assets (ROA) following adoption of the Basle Accord on capital adequacy requirements in 1988. As seen in the accounting and disclosure standards regarding off-balance-sheet transactions in Japan outlined in Table 5, unified standards currently exist only for the foreign exchange-related off-balance-sheet transactions of banks (hereinafter referred to as "new foreign exchange accounting standards"),

Table 4  
Volume of Off-Balance-Sheet Transactions

	(US\$ billions)					
	1986	1987	1988	1989	1990	1991
Notional principal amounts at year-end	1,083	1,592	2,630	4,164	5,735	7,967
Transactions on exchange	583	725	1,300	1,762	2,284	3,518
Over-the-counter transactions	500	867	1,330	2,402	3,451	4,449

Shares of On-Balance and Off-Balance-Sheet Assets in  
the Interbank Assets of Leading Banks in Major Countries

	(End 1990; %)								
	Japan	U.S.	U.K.	Germany	Italy	Canada	Netherlands	Belgium	Sweden
On-balance-sheet assets	73.5	53.5	70.0	90.2	86.8	73.5	88.8	92.7	75.2
Off-balance-sheet assets	26.5	46.5	30.0	9.8	13.2	26.5	11.2	7.3	24.8

Source: BIS (1992)



Table 5  
 Administrative Circulars Regarding Off-Balance-Sheet Transactions<sup>1</sup>  
 (Applicable only to banks; underlined sections apply to general companies including banks)

		Currency	Interest Rates	Securities
Futures	Accounting standards	- New foreign exchange accounting standard	- Regarding accounting rules for futures and options transactions <sup>2</sup> (Banking Bureau administrative notice of July 1989 and March 1990)	- <u>Accounting rules for futures transactions in securities</u> (Japanese Institute of Certified Public Accountants, October 1985)
	Disclosure standards	- <u>Regarding the disclosure of market values of marketable securities, futures, and options transactions</u> <sup>3</sup> (December 1990) - <u>Position paper (Section I) concerning accounting standards for futures and options transactions</u> (Business Accounting Deliberation Council, May 1990)		
Options	Accounting standards	- New foreign exchange accounting standard	- Regarding accounting rules for futures and option transactions <sup>2</sup> (Banking Bureau administrative notice of July 1989 and March 1990)	
	Disclosure standards	same as for Futures	same as for Futures	same as for Futures
Swaps	Accounting standards	- New foreign exchange accounting standard	- Circular of the Federation of Bankers Associations of Japan, stipulating the same treatment as for currency swaps (March 1990)	—
	Disclosure standards	—	—	—

<sup>1</sup> In addition, the following reports have been completed regarding approaches toward practical application of these standards. However, they do not have power of enforcement:

- Research report No. 3 of the Accounting Systems Committee of the Japanese Institute of Certified Public Accountants (JICPA), "Accounting Procedures for Currency Swaps" (July 1987), and research report No. 4, "Business Accounting Procedures and Disclosure of Currency Options Transactions" (April 1988).
- Report of Business Accounting Deliberation Council (BADC), "Position Papers (Section II) concerning Accounting Standards for Futures and Options Transactions" (May 1990).
- Report of Corporation Finance Research Institute (COFRI), "Investigative Study for the Establishment of Accounting Standards for Options Transactions" (July 1992).

<sup>2</sup> Following the rearrangement and integration of various administrative circulars, this was absorbed into the April 1, 1992 notification issued by the Banking Bureau of the Ministry of Finance, "Considerations Regarding Basic Factors Concerning the Business Operation of Ordinary banks."

<sup>3</sup> Following the rearrangement and integration of various administrative circulars, this was absorbed into the July 20, 1992 circular, No. 1002 issued by the Securities Bureau of the Ministry of Finance, "Circular Concerning Procedures for Disclosure of Corporate Business Conditions."

where market value accounting (MVA) is adopted in the form of converting the value of foreign currencies at current exchange rates. Meanwhile, there are no disclosure standards for swap transactions, and the matter is left to voluntary disclosure.

Accounting and disclosure rules applicable to specific types of transactions are summarized below.

*a. Futures*

Long and short positions are not registered on the balance sheet at time of contract. If margin and guarantee deposits are accepted in cash, including cases in which substitute securities are accepted in consignment transactions, they are registered on the balance sheet.

There are two accounting standards used for the recognition of profits and losses: "settlement basis" and "mark-to-market (MTM) basis." Under the former, profit or loss of the futures contract arising from fluctuations in the prices of futures are recognized at the settlement date. In this case, recognition of profit or loss is only made when the contract is settled by conducting a reverse transaction. As opposed to this, under MTM accounting, MTM differentials arising from fluctuations in the prices of futures are recognized as profits or losses whenever values are marked to the market. MTM accounting can be said MVA.

In the case of banks, in accordance with new foreign exchange accounting standards, MTM accounting is applied to transactions in currency futures. However, settlement basis is applied to transactions in interest rate futures and other. In the case of non-financial corporations, settlement basis accounting is applied to transactions in all types of futures.

Regarding disclosure standards, all corporations including banks must disclose market values of futures contracts in compliance with the July 20, 1992 Administrative Circular No. 1002 issued by the Securities Bureau of the Ministry of Finance.

*b. Options*

The most important point in options transactions is the accounting and valuation procedures with respect to premiums. Under current standards, premiums paid are listed as assets, and premiums received as liabilities on the day of payment or receipt.

Regarding the valuation of option premiums for currency options contracted by banks, the new foreign exchange accounting standards stipulate that profit or loss must be recognized at closing date after adjusting the premiums for prevailing prices—in other words, MTM accounting is applied. In case of other types of options, profits and losses are recognized at time of reverse transaction, or on the exercise date for termination.

The latter rules apply to all kinds of options contracted by non-financial corporations.

Banks and non-financial corporations face the same disclosure rule which currently only applies to listed options. The rule requires that option premiums be carried on the

balance sheet, and that the market value of option transactions corresponding to the option premiums at closing dates and the unrealized profit or loss be disclosed separately by type of option transaction with long and short positions as well as calls and puts.

*c. Swaps*

Accounting rules for currency and interest rate swap transactions by banks are based on accrual basis and market value accounting (MVA) has not been adopted. Under these arrangements, the value of swapped interest payments is calculated for the period, and unpaid amounts set-off and registered under "accrued revenues or expenses." Notional principal amounts of swap transactions do not appear in the balance sheet. Regarding profits and losses, the value of swapped interest is calculated for the period and the differential remaining after set-off is recognized as profits or losses.

In case of swap transactions of non-financial corporations, there are no definite accounting standards, although the Japanese Institute of Certified Public Accountants (JICPA) showed examples of swap accounting procedures in its Research Report No. 3 of its Accounting System Committee, "Accounting Procedures for Currency Swaps" issued July 1987. It is said that most companies treat currency swaps as long-term foreign exchange forward contracts. In this case, profits and losses from forward contract must be assigned to the respective periods up to settlement day.

Disclosure requirements for swap transactions are generally limited to entry of the above items in the balance sheet and profit and loss statements. In this connection, the report makes the following recommendation for cases in which the creditor of the underlying liability is not identical to the creditor of the swapped liability. For such cases, in view of the possibility of default of the counterparty, JICPA has indicated that underlying liabilities should be noted in the balance sheet as contingent liabilities, because the underlying liability continues to exist legally until final settlement day.

The foregoing valuation standards are summarized in Table 6.

## **2. Accounting problems of off-balance-sheet transactions**

### *Accounting problems*

The following problems are generally pointed out in connection with the accounting of off-balance-sheet transactions under current Japanese accounting practices.

- (i) Market value accounting (MVA) is partially adopted to off-balance-sheet transactions. However, MVA is essential to recognize correctly the periodic profits and losses of the off-balance-sheet transactions, in futures, swaps, and options because the price of off-balance-sheet financial instruments fluctuates from time to time, and because these transactions are not reflected in the balance sheet.
- (ii) It is difficult to evaluate the risk involved in off-balance-sheet transactions, because there is a wide range of products and combinations, and these transactions can become highly complex. Furthermore, the combination of individual risks makes it

Table 6  
Valuation Standards for Off-Balance-Sheet Transactions

		Banks		Non-Financial Companies	
		Accounting standard	Disclosure standard	Accounting standard	Disclosure standard
Futures	Currency	Mark-to-market basis	Mark-to-market basis	Settlement basis	Market value
	Interest rates	Settlement basis	Market value	Settlement basis	Market value
Options	Currency	Market value	Market value*	Settlement basis	Market value*
	Interest rates	Settlement basis	Market value	Settlement basis	Market value
Swaps	Currency	Accrual basis	No standards	No standards	
	Interest rates	Accrual basis	No standards	No standards	

\* Market value for options applies only to listed options on exchanges.

difficult to gauge the total combined off- and on-balance-sheet risks facing a bank.

(iii) It is difficult to gain an overall assessment of off-balance-sheet transactions, because there is no unified standard for accounting and disclosure.

With the growth of off-balance-sheet transactions, conventional accounting methods can no longer gauge the overall profit and loss and risks of a bank, nor can they provide an adequate picture of a bank's actual financial conditions. As these off-balance-sheet transactions continue to expand, both in terms of volume and content, there is an urgent need to formulate a unified accounting standard capable of projecting a realistic view of profit and loss as well as the risks involved. There is also a growing opinion that financial statements must be supplemented by augmenting disclosure requirements, because off-balance-sheet transactions, by nature, cannot be fully reflected in the balance sheet and profit and loss statements, and because there remain many problems to examine before the establishment of new accounting standards (BIS (1992)).

#### *Need for the adoption of Market Value Accounting (MVA)*

To reiterate, Japanese accounting standards for off-balance-sheet transactions are based on the realization principle and historical cost accounting (HCA). The only exception is found in the new foreign exchange accounting standard which stipulates the application of MVA to currency-futures and currency-options transactions undertaken by banks. However, it is clear that under realization basis accounting, profits and losses of

off-balance-sheet transactions are not recognized until settlement, and, in the interim, there is no way of indicating the hidden profits and losses or risk exposure in the balance sheet and profit and loss statements. Thus, an accurate grasp of a company's off-balance-sheet transaction position cannot be gained from the financial statements. Recently, many banks seem to be using MVA for internal control purposes. However, this will lead to other problems such that off-balance-sheet transactions might give rise to major disparities between announced profits and internal control profit figures (Bank of Japan (1993)).

It has also been pointed out that the failure to apply MVA to off-balance-sheet transactions may have a negative impact on the sound development of the market. An example of this type of problem can be found in the swap market. For purposes of controlling credit risks, participants in swap transactions normally establish trading limits for transactions with each individual counterpart. From the point of view of maintaining active trading, it is thought important to cancel outstanding contracts before termination in accordance with trading conditions so as to secure enough room for further trading within the limits. American banks, which operate under MVA, agree to contract cancellations because their profits and losses are not affected by whether they accept cancellations or not. On the other hand, Japanese banks are reluctant to agree to contract cancellation, because MVA is not applied to their swap transactions, and Japanese banks can prevent the surfacing of risks and hidden profits and losses by not accepting cancellations before termination. This has given rise to various problems in the Tokyo markets, particularly in markets where Japanese banks are the leading participants. For instance, in the yen interest rates swap market which is dominated by Japanese banks, their reluctance to accede to cancellation has had a detrimental effect on the development of the market by posing as an obstacle to the smooth operation and formation of market rates.

Other manifestations of this basic problem can be seen in the strategy adopted by various Japanese banks which do not operate swap transactions by themselves but concentrate the transactions in the hands of swap houses as overseas subsidiaries. A commonly given reason for this strategy is that the accounting standards of swap transactions by the parent bank are not MVA. Some observers point out that this strategy presents problems because swap houses with low capitalization are far less capable of absorbing risks than their parent banks.

It is being increasingly said that these problems cannot be resolved unless MVA is applied to off-balance-sheet transactions. Objective market values for the off-balance-sheet transactions examined in this section can be relatively easily determined. For this reason, it is important to consider the possibility of including unrealized holding gains and losses generated from not only foreign exchange-related transactions of banks but also all types of off-balance-sheet transactions.

*Hedge accounting practices*

To examine a case in which a futures transaction is used to hedge the risks from a spot transaction, suppose HCA is applied to the spot transaction and mark-to-market (MTM) accounting to the futures contract. In this case, unrealized holding gains or loss accruing from the spot transaction will not be recognized at the time of closing books, while unrealized holding gains or loss from the futures contract will be duly reported. The problem hence is that the economic objective of hedging, which is to set off the profit or loss from the spot transaction with the profit or loss from the futures transaction, is not recognized in the accounting system. In order to avoid this problem, "hedge accounting" practices have been adopted in the United States and the United Kingdom to remove the time lag in the recognition of profit and loss accruing from the underlying transaction and the hedging instrument. Specifically, this involves matching the points of recognition for the two transactions at the later of the two points the method is termed to be "delayed hedge accounting".

While Japan has not yet adopted "hedge accounting" rules, there exist the opinion that such rules must be introduced in order for hedging effects to be recognized in the accounting system. On the other hand, it is argued by not a few that special caution must be exercised in the adoption of hedge accounting. This is based on the following considerations: (i) in actual practice, there is no one-to-one relation between underlying positions and hedging transactions and it is difficult to apply the rules as theoretically indicated; and (ii) if transactions subject to hedge accounting are ambiguously defined, this could encourage manipulation whereby the loss from speculative transactions is intentionally delayed by misrepresenting them as hedging transactions.

Regarding the conditions which must be met for hedge accounting, in the case of Japan, the Business Accounting Deliberation Council has made the following recommendations in its Position Paper on Accounting Standards for Futures and Option Transactions, issued in May 1990. The Council has stated that "prior tests" and "posterior tests" must be satisfied. The "prior tests" consist of: (i) the transaction must be clearly recognized by the company as a hedging transaction; or, (ii) the company must have clear internal rules and organization to identify of hedging transactions, and the transaction in question must be processed according to these stipulations. The "posterior tests" consist of: (i) a high correlation must exist between price fluctuations in the underlying asset being hedged, and the futures transaction; or, (ii) the profit or loss from the futures transaction must significantly offset the profit or loss from the underlying transaction which is being hedged. It has been argued elsewhere that in addition to these conditions, companies should be required to declare a hedging transaction and to prepare proper documentation.

### **3. Outline and problems of taxation of off-balance-sheet transactions**

#### *Taxation of profits and losses*

##### *a. Tax accounting of off-balance-sheet transactions*

Although tax accounting rules for off-balance-sheet transactions have not been made clear by legislation, ministerial regulations or circulars, profits and losses accruing from off-balance-sheet transactions are, in principle, subject to consolidated taxation for the period in which they are realized, regardless of whether the entity undertaking the transaction is a corporation or an individual.

However, the situation is different for currency futures and options contracted by banks which come under the market value accounting (MVA) rules of the new foreign exchange accounting standard. In accordance with these rules, unrealized holding gains and losses are subject to taxation during the pertinent period. As for currency swaps, because the same accounting procedures as for long-term foreign exchange forward contracts can be applied, the same tax accounting rules are also applied. In this case, the recognition of foreign exchange gains or losses accruing to the forward contract on the principal amount is subject to the following tax accounting rules. If an “acquisition-conversion approach” —converted at the exchange rate prevailing at the time of acquisition— has been used, recognition is made at redemption. If a “period-end conversion approach” —converted at the exchange rate prevailing at the end of the business year— has been used, recognition is postponed until within one year of the scheduled date of principal repayment.<sup>2</sup>

##### *b. Compatibility of the tax accounting of various off-balance-sheet transactions*

As described, the new foreign exchange accounting standard is applied to currency futures and options transactions undertaken by banks, but not to other futures and options transactions. And the tax treatment of currency futures and options is different from that of other futures and options. As a result, it cannot be said that consistency has been maintained in either the tax or accounting treatment of different off-balance-sheet transactions.

#### *Transaction taxes*

##### *a. Summary of bourse tax and securities transaction taxes*

All off-balance-sheet transactions processed through an organized exchange are subject to a bourse tax as stipulated under the Bourse Tax Law. The tax rates shown in

---

<sup>2</sup>When treating currency swaps as long-term foreign exchange forward contracts, discrepancies arise between business and tax accounting practices. As indicated, foreign exchange gains and losses are allocated to the pertinent period under business accounting practices, while taxation is delayed under tax accounting rules. This implies that, in actual practice, tax statements must be adjusted when filing returns. Alternatively, tax amounts based on foreign exchange gains and losses allocated to the pertinent periods can be credited to a tax reserve and reported in the “Long-Term Reserves for Corporate Taxes” account.

Table 7 are charged to both parties of a transaction. However, taxation of yen-U.S. dollar currency futures and U.S. dollar interest rate futures has been postponed until March 1995 according to Article 3 of the supplementary provisions of the Bourse Tax Law. On the other hand, forward transactions and over-the-counter options transactions which do not pass through an exchange are not subject to a bourse tax.

Securities transaction taxes are not applicable per se to such off-balance-sheet transactions as futures and options contracts. They are charged at settlement if the actual delivery of securities is involved.

*b. Differences in taxation between on-balance-sheet and off-balance-sheet transactions*

As shown, off-balance-sheet transactions such as futures and options are subject to bourse taxes but not securities transaction taxes, while on-balance-sheet transactions are subject to securities transaction taxes. Because of differences in the relevant tax rates, problems of proportionality arise between the two classes of transaction. A specific case in point, as shown in Table 8, is the wide disparity in tax rates applicable to spot and futures transactions in government bonds and stocks.

Table 8 clearly indicates that the tax burden on investors is considerably lower for futures transactions as compared to spot transactions. This is one of the reasons why dealing transactions are, in practice, concentrated in the futures markets.

Table 7  
Tax Rates on Exchange Transactions\*

Futures transactions (excluding yen deposit rate futures)	0.001%
Yen deposit rate futures	0.0001%
Option transactions	0.01%

\* Tax rates are subject to Article 10 of the Bourse Tax Law and Article 4 of the Supplementary Provisions to the same law.

Table 8  
Tax Burden of Spot and Futures Transactions<sup>1</sup>

Category of Securities	Spot Transactions	Futures Transactions <sup>2</sup>
Government bonds	0.03%	0.002%
Stocks	0.3%	0.002%

<sup>1</sup> Cost born by investor trading through securities companies.

<sup>2</sup> Assuming trading through reverse transaction (two-way cost).



## C. Bank Disclosure

### 1. *Significance, purpose, and effects of bank disclosure*

The significance of disclosure lies in the promotion of self-efforts to ensure the sound business practices and financial position by disclosing information regarding financial conditions to shareholders, depositors, and other users, thereby maintaining greater transparency. Article 21 of the Banking Law stipulates that documents explaining current business and financial conditions (disclosure journals) must be available at all main offices of a bank. The actual methods of disclosure are summarized in Table 9.

It is generally said, however, that the current extent and content of bank disclosure in Japan is not adequate. Because bank disclosure is not only of interest to professional investors but also to a large number of depositors, the disclosure of risk-related information is of crucial significance in ascertaining the safety and stability of banking system. However, the provisory clauses of Article 21 of the Banking Law relieves banks from disclosing the following information: "matters which will undermine financial order, infringe upon the secrecy of depositors and other customers, hamper banking operations unduly, or incur an excessive burden of expenses for complication." It is frequently argued that, as a result of this proviso, depositors and other interested parties are unable to gain sufficient access to risk-related information.

The effects of bank disclosure are important not only for recipients but also for banks themselves. The effects on banks are as follows: (i) the "feedback effect," by which, information disclosed to users would influence the behavior of users and affect the bank's financing activities; (ii) the "feedforward effect," by which, anticipating the

Table 9  
Statutory Regulations Regarding Bank Disclosure and Medium of Disclosure

Applicable Law	Medium
Commercial Code	Financial statements, documents on file, public announcement of financial accounts
Banking Law	Disclosure journals
Securities and Exchange Law	Securities notification, annual securities report, biannual report, ad hoc reports
Listing requirements of securities exchanges	Reports on financial statements, reports on consolidated financial statements, other occasional disclosure (filing system)
Non-binding	Annual report, business report, public relations activities, investor relations activities

Source: Nagata (1991)

expected reaction of users to information to be disclosed, banks would adjust or change their own behavior prior to disclosure. The latter is thought to contribute significantly to the promotion of better self-discipline on the part of management and the maintenance of sound banking practices.

One of the functions of disclosure is to supplement accounting standards. For instance, in a country such as Japan where accounting principles are based on historical cost accounting (HCA) and not on market value accounting (MVA), the notation of current market values in disclosure information can serve to provide a fair view of current asset values.

## **2. Essential bank disclosure issues**

Essential issues and problems as pertaining to banks have been identified by the Financial System Research Council, an advisory body to the Minister of Finance, in which the promotion of wider disclosure rules has been discussed. In this section, the following issues constituting the most important questions will be discussed: (i) for whom disclosure is to be made; (ii) whether disclosure should be compulsory or not; and (iii) what will be the scope, and what valuation method will be applied to assets subject to disclosure.

### *Disclosure for whom?*

The provisions for disclosure under Article 21 of the Banking Law are not clear as to for whom disclosure is to be made. However, because they exist parallel to disclosure provisions in the Commercial Code and the Securities and Exchange Law, it is generally assumed that primary importance is assigned to depositors, investors and other users.

It has been argued that in determining the future format of bank disclosure, priority should be given to such formats as will satisfy the requirements of general users. At the same time, disclosure should be sufficiently thorough and detailed to be of value to professional investors.

### *Should disclosure be compulsory?*

As stated above, disclosure can be considered not merely a service for users, but also a means for promoting and securing sound bank management practices. If so, it can be argued that specific significant information to be disclosed and basic conceptual framework should be defined by law.

The problem with legal specification is that banks will interpret the rules to represent a maximum level, whereas in reality, such rules would be merely setting minimum levels for disclosure. From this perspective, many observers have commented that it is preferable for companies or banks to voluntarily disclose, as part of their responsibility, any information significant for users. It would be ideal that as this approach became established, banks opting for full disclosure would be highly rated in the market. Regarding the highly sophisticated new financial instruments which are continuously being intro-

duced, there is every possibility that legal measures cannot be adopted quickly enough to catch up with the ever-increasing line-up of instruments. This is cited as another factor in arguing that disclosure standards cannot be based entirely on statutory compulsion. Nevertheless, in order to maintain a certain level of comparability among the disclosure statements of various banks, it would be a rational and more effective approach that unified standards be established that at least define the major items to be reported on.

#### *Scope and asset valuation method*

While the scope of disclosure has gradually increased in Japan, it has been commented that, in certain areas, it is still inadequate compared to the United States and other countries. The status of disclosure is examined below with respect to major assets and transactions.

##### *a. Securities*

In accordance with the December 1990 circular of the Ministry of Finance, "Regarding the Disclosure of Market Values of Marketable Securities, Futures, and Options Transactions," all corporations have been required to disclose market value information for marketable securities from 1991 fiscal year, and for bonds from 1992 fiscal year.

In response to these developments, banks are currently disclosing information on their securities holdings by dividing them into securities of trading purpose and investment securities. For each, book values, market values, and unrealized holding gains and losses are disclosed. However, this practice is subject to the following problems and limitations: (i) because specified money in trust (*tokutei-kinsen-shintaku*) and fund trusts are not defined as securities under the Securities and Exchange Law, these assets are not subject to market-value disclosure requirements; (ii) because hidden profits and losses are netted out, there is no indication of the gross size of each; and (iii) because information for private securities is not disclosed, securities for which the bank is holding particularly large hidden losses are not identified.

As shares issued by subsidiaries and affiliates and then held by the parent can be characterized as direct investment by the parent, it is more appropriate to evaluate these securities using the equity method than to undertake market value accounting (MVA). It has been pointed out that in order to assure proper valuation when evaluating such securities according to the equity method, the financial statements of subsidiaries and affiliates must first be amended to reflect current market values.

##### *b. Off-balance-sheet transactions*

Regarding disclosure requirements for off-balance-sheet transactions, as stated in Section III [B], the dominant view is that some form of supplementary disclosure of market values is necessary for transactions to which MVA principles have not been applied. In addition, the formulation of disclosure standards for swap transactions is considered urgent.

*c. Segment information*

Following the May 1988 Business Accounting Deliberation Council recommendation report, "Position Paper on the Disclosure of Segment Information," the Securities Bureau of the Ministry of Finance issued a circular entitled "the Disclosure of Segment Information under the Securities and Exchange Law" in September of the same year. In compliance with this circular, segment information for consolidated accounts has been disclosed since 1990 fiscal year.

However, the following problems and limitations have been identified concerning the content of segment information disclosure: (i) segmentation of business areas is left to the judgment of management of the company; (ii) not enough information is provided to judge whether the allocation of operating expenses is appropriate; and (iii) segment information by geographic area is not disclosed. To overcome these limitations, amendments were made to the Rules Governing Consolidated Financial Statements (*Renketsuzaimu shohyo-kisoku*) in April 1993 requiring disclosure of the following to be annotated in consolidated financial statements: (i) operating profits and losses accruing to domestic and foreign operations from 1994 fiscal year; (ii) assets values by segment from 1995 fiscal year; and (iii) segment information by geographic area from 1997 fiscal year.

*d. Advance guarantee*

Under current rules, debt guarantees are subject to disclosure requirements, while advance guarantees are not. However, when a guarantee becomes necessary, a creditor will probably exercise its right to activate the guarantee. Therefore, from the perspective of the guarantor, there is no decisive difference between debt and advance guarantees. For this reason, it has frequently been argued that advance guarantees should also be subject to disclosure rules.

### **3. Disclosure of risk-related information**

*Current disclosure of risk-related information*

With the exception of certain city banks, risk-related information has seldom been disclosed in Japan. For this reason, the Financial System Research Council's Working Group on Disclosures included the study of risk-related information. As a result, from 1992 fiscal year, disclosure of risk-related information began to be required. Under these new rules, city banks, long-term credit banks, and trust banks are required to disclose the gross value of "claims against their customers who went bankrupt" and "claims for which interest is more than six months past due". Regional banks are also required to disclose the gross value of "claims against their customers who went bankrupt," while they are not required to disclose the gross value of "claims for which interest is more than six months past due". There are some criticism that regional banks should also disclose the value of the latter claims. Furthermore, regarding claims against customers whose interest pay-

ments have been reduced or deferred, while neither category of banks is required to disclose this information for the time being, the Working Group will continue studying the issue.

*Desirable disclosure of risk-related information*

It is sometimes argued that disclosure of information concerning impaired loans will generate unnecessary concern among users, and that such disclosure is problematic from the perspective of maintaining the stability of the credit system. On the other hand, many observers have commented that a far greater problem arises from the failure to disclose risk-related information in that users are forced to make a blind selection of banks. Based on this position, it is desirable that regional banks will disclose information on claims in arrears. There is also a growing view that disclosure standards should be expanded to close any loopholes created by not requiring the disclosure of claims whose loan terms and conditions have been altered, such as through the reduction or deferment of interest payments.

In addition, the following issues have been identified with regard to the disclosure of information on risk assets.

First, when the value of impaired loans is disclosed, the net value obtained by subtracting the collateralized portion from the total value may lack objectivity in the assessment of collateral. Therefore, information on impaired loans should basically be disclosed in gross terms in order to facilitate a proper assessment of impaired loans.

Second, the mere disclosure of figures is insufficient and there is a need to reveal information concerning the background and reasons for bankruptcy of their customers and whether these problem assets are covered by reserve funds. In the United States, as well as in the United Kingdom and France, detailed information is provided regarding the reasons and background for increases/decreases in impaired loans, along with comments on reserve positions and other aspects of risk management. It is believed that the disclosure of such information allows users to gain a better grasp of the risk-management stance of banks without giving rise to undue concern. However, in this situation, it is thought desirable for banks to be able to make appropriations to allowances for credit losses at their own discretion according to their risks (*see* Section III E.).

The third issue concerns measures to prevent undue concern and agitation among users as a result of the disclosure of risk-related information. There are various available measures, such as improving the credit rating system and training analysts specializing in the analysis of risk-related information and other bank information for the consumption of bank users. In addition, it is important to promote and to take advantage of the learning effect associated with the implementation of disclosure. Through continued disclosure, users initially unable to understand risk-related information will gradually show more interest and be able to better understand the information disclosed.

## D. Problems Related to Consolidated Accounting

### 1. *The scope of consolidation*

Consolidated financial statements are prepared by a parent company to present a comprehensive picture of the financial conditions and business performance of a group of companies which constitute a single business unit. The Commercial Code does not make provisions for consolidated accounting; consolidation exists solely in the context of the Securities and Exchange Law. Thus, consolidated accounting by banks is based on that Law.

Subsidiaries are subject to consolidated accounting if the equity owned by the parent (including other subsidiaries) exceeds 50% of the outstanding shares. However, in special cases, such as if the subsidiary has declared bankruptcy or is undergoing reorganization, subsidiaries are excluded from consolidation under Article 5, Paragraph 1 of the Rules Governing Consolidated Financial Statements (*Renketsu-zaimu-shohyo-kisoka*). Furthermore, subsidiaries can be excluded from consolidation, if they are of sufficiently little importance, based on the value of assets and sales, such that their exclusion does not obstruct rational judgment of the financial condition and business performance of the group, under Article 5, Paragraph 2 of the above—this is called the “principle of materiality.”

The application standards for this “principle of materiality.” were defined in Procedures Regarding the Rules Governing Consolidated Financial Statements (*Renketsu-zaimu-shohyo-kisoku-toriatsukai-yoryo*) before 1993 fiscal year. This allowed the exclusion of any subsidiary whose assets, sales, and profits did not exceed 10% of aggregate assets, sales, and profits of the consolidated group—the “10% rule.” Furthermore, the Procedures allowed to exclude the application of “the equity method”<sup>3</sup> to the affiliate whose profits did not exceed 10% of aggregate profits of the consolidated group—i.e. application of the “10% rule.”

Some practitioners have commented that Japanese 10% exclusion standard may be too lax as compared to other countries, especially in view of the growing need for international comparability reflecting the continued globalization of Japanese companies. Moreover, consolidated accounting in some countries is based not only on equity ownership standards, but also on more substantial standards. An example of this is seen in the United Kingdom “control of the membership of the board of directors of another company” standard under the United Kingdom Statement of Standard Accounting Practice No. 14. Given that the purpose of consolidated accounting is to disclose the financial conditions of a business group which can be identified as a single business unit, it has been argued that Japan should also introduce more substantial standards.

---

<sup>3</sup>Profits and losses of the affiliate of which the parent's equity position is 20-50% are reflected in parent consolidated investment accounts in proportion to the position. This method is called “the equity method.”

Based on these considerations, the “10% rule” defining the scope of subsidiaries subject to consolidation as well as the application of the equity method was abolished in the April 1993 revision of Procedures Regarding the Rules Governing Consolidated Financial Statements, which will go into effect from 1994 fiscal year. Moreover, the application of the “principle of materiality” will hereafter be based on more substantial judgment of importance. The Japanese Institute of Certified Public Accountants (JIC-PA) is currently formulating practical guidelines regarding judgment standards.

## **2. Problems related to bank's subsidiaries**

Traditionally, there has been very little interest in the consolidated statements of Japanese banks. This is partly because bank's subsidiaries were subject to various regulations and mainly because banking operations and activities were concentrated in the parent bank itself. This situation has recently been altered by financial liberalization and globalization which have stimulated overseas subsidiaries to actively increase the level of their operations. Another factor has been the June 1992 enactment of the “Financial System Reform Laws” which enables financial institutions of each category (banking, trust business, security business) to enter into activities of other business fields through their newly established subsidiaries. These developments seem to have instigated greater awareness that it is essential to consolidate the business activities of subsidiaries in order to grasp the financial conditions of bank as a business group. At the same time, there is now a greater awareness of the need to give serious attention to accounting standards regarding the treatment of these subsidiaries.

Japanese Anti-Monopoly Law, the “Prohibition of Private Monopolization and Maintenance of Fair Trade Act” currently stipulates that, in principle, banks may not own more than 5% of the outstanding shares of any domestic company. On the other hand, the Fair Trade Commission allows the establishment of wholly-owned subsidiaries whose business areas are directly related to banking operations such as internal control functions which normally are undertaken by the bank itself, or ancillary services such as the management of business-use real estate property, employee welfare services, and subcontracted clerical services (Table 10). And, since April 1993, subject to the approval of the Minister of Finance and the Fair Trade Commission, banks have been permitted to hold equity positions in excess of 50% in securities business or trust banking subsidiaries. The consolidated financial statements rule mentioned under (1) above is applied to these bank subsidiaries, in principle.

On the contrary, 5%-affiliates—affiliates in which the bank's equity position is not exceeding the 5% mark and carry out such operations as credit guarantee, credit card services, and consumer credit (Table 10)—are not subject to consolidated accounting requirements because the bank does not own majority of the affiliates' outstanding shares. The unified disclosure standards of the Federation of Bankers Associations of Japan only require the disclosure of the description of business activity, capitalization,

Table 10  
 Categories of Bank Affiliates\*  
 (Circular No. 1968 of the Banking Bureau of the Ministry of Finance dated July 3, 1975,  
 "Regarding the Relation between Financial Institutions and their Affiliates")

Category	Equity position	Operation
Subcontracted banking operations	100%	Deposit operations, consumer lending
Non-basic services provided primarily to parent bank	100%	Real estate management, employee welfare services, subcontracted clerical operations (collection and delivery, etc.)
Ancillary services	5%	Credit guaranteeing, factoring, mortgage securities, consumer credit, etc.
So-called "peripheral operations"	5%	Leasing, venture capital, management consultancy, jointly capitalized home financing

\* Except for securities- and trust banking-related subsidiaries permitted to be held pursuant to the enactment of the Financial System Reform Laws.

and equity positions. Therefore, investors and other users have no access to business information regarding affiliates unless these affiliates themselves disclose these information.

In fact, the level of control which parent banks wield over these affiliates varies greatly. In certain instances, the parent bank provides executives but exercises no control over management. Conversely, there are cases in which the parent bank is directly involved in almost all of the affiliate's important management policies. Even in cases where the parent bank does not normally interfere in the management, it often provides substantial financial assistance whenever an affiliate is experiencing financial difficulty.

The implication is that even 5%-affiliates may have a significant impact on the business performance of banks. Based on this consideration, many point out that there is need to implement greater disclosure of the business and financial conditions of bank affiliates. As a possible example, all 5%-affiliates performing ancillary services and operations which exceed a certain scale may be required to make disclosure on their own. Or, disclosure may be required on the basis of the actual relations which exist between the parent bank and its affiliates as defined by the make-up of the executives and the conditions of stock ownership and control among group companies and affiliates. Based on this, banks can be required to include such affiliates in consolidated statements or to disclose information concerning loans provided and executives dispatched to affiliates.



### **3. Problems of consolidated tax payments**

As one of the additional issues related to consolidated accounting, the problem of consolidated tax payments is sometimes pointed out. Consolidated tax payment is a system which allows company groups, as defined primarily by stock ownership positions, to pay corporate income taxes on aggregated group profits and losses—i.e. “company group-based taxation.” This system has been adopted by such countries as the United States, the United Kingdom, France, Germany, the Netherlands, Spain, Sweden, Denmark, Mexico, and Australia. Countries which have not adopted this system include Japan, Italy, Switzerland, Belgium, and Canada (CEC (1992)).

The basic idea expressed in countries which have adopted this system of taxation can be summarized as follows. It is more rational to determine the aggregated taxable income of a group of companies when such groups constitute a single economic entity. When no real differences exist between branches and subsidiaries, there is no reason to treat these differently for tax purposes.

It is said that in Japan, it is relatively easy to hide or generate profits or to undertake other balance sheet manipulation by using subsidiaries. From the perspective of maintaining objective standards of taxation, it has been argued that Japan should adopt a consolidated taxation system under which any balance sheet manipulation would have a neutral overall impact.

On the other hand, the adoption of consolidated taxation in Japan can be expected to have an impact on the total amount of corporate tax collected and appropriate measures will have to be taken. Furthermore, such technical questions as stock ownership ratios, cost allocation standards, and the treatment of dividends as well as the issue of how to harmonize with the current legal framework of accounting principles must be resolved.

## **E. Problems Related to the Allowance for Credit Loss System**

### **1. Role of the allowance for credit losses and summary of the current system**

#### *Role of the allowance for credit losses*

Banks always face the possibility of being unable to collect a portion of loans extended to borrowers. For this reason, ideally, only collectable loans should be registered as assets on balance sheets. However, in actual practice, it is difficult for banks to accurately project the value of non-collectable loans. As an alternative, banks estimate future losses stemming from bad loans and accumulate a credit loss allowance. Because such allowances act as a buffer for covering losses when losses actually arise, they are said to be directly related to the soundness of bank management. Provision for possible loan losses, one of the sub-accounts of credit loss allowances are treated as supplementary capital in the capital adequacy requirements of the Bank for International Settlements (BIS).

In certain instances, credit loss allowances are treated as tax-deductible charges. In such cases, there is a tendency to build up allowances to take advantage of their tax-relief status. As such, there is a close relationship between tax rules and credit loss allowances.

### *Summary of the Current Japanese System*

Credit loss allowances consists of three sub-accounts as stipulated by bank accounting standards: "provision for possible loan losses," "special reserve set out to write off loans," and "provision for losses specified overseas claims (reserves for losses arising from overseas investments)." These will be explained below.

#### *a. Provision for possible loan losses*

The "provision for possible loan losses" is stipulated under Article 52 of the Corporate Income Tax Law which provides for the appropriation of a certain percentage (as maximum limit) of loans, such as lending, call loans, and promissory notes accepted, to the allowance. Amounts thus appropriated to the allowance are debited as losses. Tax-relief appropriations to the allowance are, in principle, set at 0.3% for banks and insurance companies, and 0.348% for *shinkin* banks and other credit associations. Alternatively, financial institutions may opt to use an actual bad-loan ratio calculated on the basis of bad loans incurred in the past three years.

It should be noted that Bank Accounting Standards require that the maximum amounts allowed under the tax laws should at least be credited to the provision.

#### *b. Special reserve set out to write off loans*

In case such as commencement of liquidation, filing for bankruptcy or application for corporate reorganization of the borrower, it has become apparent that the loan to the borrower is more likely to be in part on wholly uncollectable. But at that time final amount of losses cannot be fixed. In such cases banks appropriate estimated non-collectable amounts to the "special reserve set out to write off loans" while making no changes in book value.

These reserves, in principle, can be debited to losses without tax in accordance with certain set of standards. However, when these standards are not met and a bank intends to make appropriations to reserves with tax, it must report such to the Ministry of Finance before the appropriations.<sup>4</sup>

#### *c. Provisions for losses specified overseas claims*

The "provisions for losses specified overseas claims" is designed to cope with country risks and provides for allowances against credit losses arising from loans to developing

---

<sup>4</sup>The circular of the Banking Bureau of the Ministry of Finance dated June 25, 1992 makes the following stipulation: "Reserves with tax should be undertaken by financial institutions on their own initiative and, as such, the authorities will not force financial institutions to take such measures, nor will they disapprove of such action."

countries and other overseas borrowers where the risk of non-recovery exists. This system provides for the appropriation of 1% or more in provisions of the total outstanding end-period claims against specified countries and specified types of claims. A certain portion of these provisions can be debited as losses to “reserves for losses arising from overseas investments” under Article 55, Paragraph 2, of the Special Taxation Measures Law.

#### *Allowances with tax and tax allocation*

Tax allocation is designed to recognize taxable amounts on an accrual basis and reckon them as deferred tax assets or liabilities under business accounting when the business and tax accounting periods do not overlap completely.

When tax allocation is permitted, and in case that allowances for credit losses do not fulfill the condition for tax-relief but will be certainly debited in future as losses without tax, amount of the tax should be registered as “deferred tax assets” on the balance sheets and this amount should be added to financial income. To the contrary, when tax allocation is not permitted, such deferred tax assets are not recognized.

In Japan, tax allocation can be applied only to consolidated financial statements, in order to adjust disparities between consolidated pre-tax profits and the aggregated taxable income of the individual consolidated companies. However, tax allocation is not applied to the financial statements of a single company under both the Commercial Code and the Securities and Exchange Law. As a result, when banks appropriate allowances before the condition for tax-relief is not fulfilled, the appropriation amounts act to reduce net income for the year by the full amount. It is thus said that the incentive to appropriate allowances can be easily affected by the level of current-year profits.

## **2. Comparison with credit loss allowance systems in other countries**

A comparison of credit loss allowance systems (or accounting systems for reducing the value of outstanding loans) between Japan and other countries—such as the United States, the United Kingdom, and Germany—reveals the following features.

First, the system in most countries provides the tax authorities with a certain degree of control over tax-relief allowances, as is the case in Japan. On the other hand, countries other than Japan do not require their banks to notify the tax and banking supervisory authorities in the case of appropriating allowances with tax, and the matter is left to the discretion and decision of individual banks.

Second, with respect to provision for possible loan losses which do not correspond with individual claims, Japan and Germany allow tax-relief treatment, while in the United States and the United Kingdom, in principle, all such allowances are treated with tax.

Third, when appropriating allowances with tax, Japan does not permit the application of tax allocation, while in other countries, such tax allocation is applied for adjusting

disparities arising from the time lag in the definition of profits under business and tax accounting.

As indicated, the Japanese system differs from that of major industrial countries in the treatment of tax allowances, and the need for the approval of the tax and banking supervisory authorities. Additionally, in actual practice in the Japanese case, appropriations to allowances normally tend to fall within the limits of tax-relief allowances, and sufficient allowances are not usually appropriated until the actual probability of losses becomes relatively great. This aspect of the Japanese system will require further consideration in the future.

## **F. International Harmonization of Accounting Standards and Tax Systems**

### ***1. The need for the international harmonization of accounting standards***

Accounting standards have been established as common measures to provide an accurate picture of the financial conditions of companies and banks, as well as to facilitate the comparison of the financial conditions of various entities. With the recent progress of internationalization in financial and economic transactions, there is a growing need for the international harmonization of accounting standards, which in the past have been diverse from country to country.

For instance, in order to promote the smooth and efficient capital financing in foreign countries the financial conditions of companies and banks must become more transparent to foreign lenders. By the same token, it is important for investors to be able to make international comparisons of the financial positions of companies. International harmonization of accounting standards is also of crucial interest to companies and banks which are active in overseas markets and have established a large number of overseas branches and subsidiaries. International disparities add considerably to the cost and time required for the preparation of financial statements. In addition, management faces significant difficulties in accurately grasping the overall financial conditions of its corporate groups. Furthermore, international disparities may give rise to the phenomenon of the "hollowing-out" of markets whereby transactions are shifted from countries and markets which are at a disadvantage to those at an advantage in terms of accounting standards. This phenomenon may well give rise to a new wave of international friction in the financial and economic sphere.

There are two possible approaches to respond to the need for international harmonization of accounting standards. Either common international standards can be formulated, or two or more countries may mutually recognize each others' accounting standards. While most past efforts in international harmonization have focused on mutual recognition, there is growing interest in international unified accounting and disclosure standards—i.e. International Accounting Standards (IAS) formulated by the International Accounting Standards Committee (IASC).<sup>5</sup> Because IASC is a private organiza-

tion, IAS lack legal force. However, worldwide interest in IAS has been mounting, especially following the recent indication that the International Organization of Securities Commissions (IOSCO)<sup>6</sup> intends to introduce the compulsory application of IAS in connection with international capital financing.

As of the end of 1993, IASC had adopted 31 International Accounting Standards (IAS) and announced 2 exposure drafts. While previous IAS tended to provide companies with wide-ranging options, efforts are currently being made to formulate more narrowly-defined standards. The fundamental portions of the current program are scheduled to be completed by March 1995, and there is a possibility that actual implementation may begin after the following trial period of several years. It remains uncertain whether all IOSCO member countries will immediately apply IAS rules to foreign companies seeking to procure funds in their financial markets. However, it is believed that Japanese companies which are active in international markets will have to keep IAS rules in mind as they plan for the future.

## **2. Problems related to the application of IAS to Japanese companies and banks**

While the IAS rules themselves do not in any form alter domestic accounting standards, companies whose capital is financed in international financial markets will have to adopt accounting practices conformable to IAS rules. This process will draw attention to the disparities between domestic accounting standards and IAS rules, very possibly setting the stage for the unification of the currently diverse accounting standards of different countries. Under these circumstances, it will prove increasingly difficult for Japan to maintain accounting standards which are significantly different from IAS.

The IAS rules are said to be closest to the accounting standards of the United States and the United Kingdom, and they contain many aspects which do not conform with the current Japanese standards. The application of IAS rules to Japanese companies and banks can be expected to give rise to the problems discussed below.

### *Introduction of Market Value Accounting (MVA)*

IAS Exposure Draft No. 48 entitled "financial instruments" stipulates valuation standards for financial instruments as summarized in Table 11.

While Japan has already made considerable progress in the disclosure of market values of financial instruments, IAS rules stipulate that market values of financial instru-

---

<sup>5</sup>IASC was founded in 1973 as a private organization by certified public accountants from the United Kingdom, the United States, Canada and other countries for the purpose of formulating unified international accounting and disclosure standards.

<sup>6</sup>IOSCO was founded in 1986 as an international organization consisting of the securities supervisory authorities of various countries for the purpose of promoting the fair and efficient development of internal and external securities markets through the formulation of unified international standards for securities transactions, such as common rules for disclosure and insider trading.

Table 11  
Valuation Standards for Financial Instruments Prescribed in IAS Exposure Draft No. 48

Financial Instruments <sup>1</sup>	Valuation Standard
1) Financial instruments that management intends to hold for a long term or until maturity.	Historical cost <sup>2</sup> or fair value (market value) as alternative
2) Hedging instruments	Measured on the same basis as hedged items (hedge accounting)
3) All other financial instruments	Market value

<sup>1</sup> Distinction depends on management; but assets must be assessed at market value when shifting between two categories.

<sup>2</sup> Historical cost must be devalued in the case of significant depression in market price.

ments held for short-term be reflected in balance sheets. Under these rules, specified money in trust (tokutei- kinsen-shintaku) and fund trusts would also be subject to MVA. It is thus believed that companies and banks holding large amounts of hidden profits and losses in these instruments will be significantly affected. It should be noted that IAS rules allow the revaluation of tangible fixed assets as seen in the U.K. accounting standards.

#### *Scope of consolidated accounting*

There is no major difference between Japanese and IAS thinking regarding the scope of consolidated accounting. However, IAS rules do not contain any stipulations which correspond to the Japanese “principle of materiality” for excluding subsidiaries and affiliates from consolidation. Barring exceptional cases where there is obvious proof that share ownership has not resulted in corporate control, all subsidiaries—except subsidiaries in unrelated business fields and in certain cases—of which the parent’s equity position exceeds 50% are subject to consolidation under IAS rules. In addition, the IASC has formulated standards for the consolidation of subsidiaries and affiliates with a less than 50% equity position but in which the parent exercises actual control over management. Such standards include corporate control by contract or statutory means, and the power to appoint or remove a majority of the board of directors. Furthermore, under the IAS regime, “the equity method” is applied to subsidiaries and affiliates with less than 20% equity position if the parent exerts an important influence. To the contrary, in Japan, “the equity method” is not applied when equity is below 20%. Therefore, it is expected that when IAS standards are applied to consolidated accounting, Japanese companies and banks will have to considerably expand the scope of consolidation as compared to current Japanese standards.

*Consolidation standards for overseas subsidiaries*

Under current Japanese practices, it is permissible to process the accounts of overseas subsidiaries in accordance with the accounting standards of the country where the subsidiaries are located and to introduce these figures into the consolidated statements of the parent in Japan. However, from 1995 fiscal year, overseas subsidiaries will be obligated to process their accounts in accordance with Japanese standards for inclusion in the parent's consolidated statements. For Japanese companies and banks which have a large number of U.S. subsidiaries, for example, it is feared that this new rule may make it even more difficult to grasp an accurate condition of off-balance-sheet transactions and the market value of financial assets, thus rendering the financial statements of Japanese companies and banks even less amenable to international comparison. From this perspective, the adoption of IAS standards will have the advantage of facilitating international comparison of the business performance of Japanese companies and banks.

*Expanding scope of disclosure*

Although IAS disclosure standards will not be binding on domestic Japanese accounting statements, it can be expected that the practice of making disclosure in accordance with IAS standards will gradually be established in Japan.

**3. International harmonization of tax systems***Background and methods for the international harmonization of tax systems*

The globalization of economic activities has brought about a vast increase in the international movement of people, goods, and capital, and a massive increase in multinational economic activities and transactions typically seen in the business of multinational corporations. These developments have drawn increasing attention to the need for the international harmonization of tax systems. For instance, when two or more countries have tax claims on a transnational economic transaction, the need arises to adjust these claims. When tax systems differ among the countries involved, there is a possibility that people, goods, and capital will tend to move in the direction of the countries and regions with more favorable systems—that is, with lower tax rates. This movement will both create distortions in economic activities, and give rise to incentives to correct these distortions. Particularly in recent years, when we have witnessed the movement toward market integration as in the European Community, many have begun to think that the international harmonization of tax systems is becoming increasingly important.

Nevertheless, harmonization of tax systems involves issues of national sovereignty and is not readily amenable to international adjustment. For this reason, the core portions of national tax systems, consisting of corporate and personal income taxes, have in the past been excluded from harmonization efforts which have mainly focused on tax rates on overseas investments and other limited areas. As for the methods for harmonization, the traditional approach has emphasized bilateral treaties—referred to as tax

conventions—instead of multilateral agreements.

For instance, there are two principles in the international taxation of income: (i) “taxation at source” which assigns the right of taxation to the country where the income is generated, regardless of whether the liable entity is a resident or non-resident, and (ii) “taxation at domicile” which assigns the right of taxation to the country of residence, regardless of whether the income has been generated domestically or abroad. When these two principles co-exist in various countries throughout the world, residents’ incomes generated abroad or non-residents’ incomes generated domestically may be subjected to double taxation (by the country of residence and the country of source). To avoid this double taxation, Japan has adopted a system of deducting tax amounts paid abroad from the total domestic tax liability under Article 95 of the Income Tax Law, and Article 69 of the Corporate Income Tax Law. In addition, Japan has concluded tax conventions with 39 countries.

The Taxation Committee of the Organisation for Economic Co-operation and Development (OECD) and the United Nations have formulated model tax conventions—the OECD in 1977 and the United Nations in 1979. Efforts are thus being made toward the international harmonization of the content of tax conventions.

#### *Possibilities for the International Harmonization of Tax Systems*

The current view is predominantly pessimistic because: (i) there is virtually no international consensus as to what constitutes the best tax system, (ii) the assessment of the role and importance of the tax system varies from country to country, and tax agreements are seen to infringe upon the sovereign rights of nations to determine their own fiscal policies.

Nevertheless, certain efforts have been made in recent years to achieve international harmonization through multilateral adjustment. For instance, parallel with the integration of the EC markets after 1993, the member countries of the European Community are examining ways of harmonizing tax systems, principally in the areas of value-added and other indirect taxes. It will be very interesting to see whether these attempts at harmonization bear fruit, and whether similar efforts will be successfully pursued on a global scale in the future.

*Akio Kuroda: Chief, Research Division II, Institute for Monetary and Economic Studies, Bank of Japan, (presently Assistant Professor of Economics at Meiji University)*

*Masataka Kotani: Senior Economist, Research Division II, Institute for Monetary and Economic Studies, (presently Examining Officer, Bank Supervision Department) Bank of Japan*

*Marie Ogawa: Research Division II, Institute for Monetary and Economic Studies, Bank of Japan*



**References**

- Arai, Kiyomitsu and Shonosuke Shiratori, *Legal and Conceptual Framework of Accounting in Japan*, The Japanese Institute of Certified Public Accountants, August 1992.
- Bank of Japan, "Expansion of Off-Balance-Sheet Transactions and Issues Facing Japanese Financial Markets," *Bank of Japan Quarterly Bulletin*, May 1993.
- BIS Working Group on International Interbank Relations, *Recent Developments in International Interbank Relations*, October 1992.
- CEC (Commission of the European Communities), *Report of the Committee of Independent Experts on Company Taxation*, 1992.
- Gerson, Helen, S.E.C. Purvis, and M.A. Diamond, *An Analysis of the Implications of the IASC's Comparability Project*, SEC and Financial Reporting Institute, University of Southern California, 1990.
- IASC, "Comparability of Financial Statements," Exposure Draft No. 32, 1989.
- , "Financial Instruments," Exposure Draft No. 48, 1991.
- Mueller, G.G., H. Gerson, and G. Meek, *Accounting, An International Perspective*, Richard D. Irwin, 1987.
- Nagata, Shun'ichi, ed., *Ginko Keiri no Jitsumu* (Bank Accounting Practices) (in Japanese), Kinyu Zaisei Jijo Kenkyu-kai, 1991.
- OECD, *The Future of Capital Income Taxation in a Liberalised Financial Environment*, 1991.