All change for Japanese accounting

Clay Kinney of PwC takes a look at Japan's new accounting policies as it strives to bring them in line with international standards.

While lately many have decried the reduced pace of structural change in Japan's financial industry, otherwise known as Japan's Big Bang, one area where the pace of change has been swift is in the revision of Japan's accounting regulations. In an effort to become free, fair and global, Japan has been taking dramatic steps to align its accounting policies with international accounting standards.

For the most part, members of the financial community have welcomed Japan's introduction of stricter accounting standards. However, the new standards have caused discomfort for those companies that have to report under the new rules.

Representative of the new international standards is a rule that requires the disclosure of unfunded pension and retirement liabilities.

The *Nihon Keizai* (a Japanese financial newspaper) estimated that 16% of the projected pretax returns of all listed companies would be wiped out by extraordinary losses recognised by companies that writing off their pension shortfall in fiscal 1999, in preparation for the implementation of this new rule. For example, Nippon Telephone & Telegraph alone booked a roughly ¥750bn loss for pension liabilities in fiscal 1999.

Key changes

There are six key areas of accounting changes that Japan has, or will, introduce over the next two years. In addition, the government is considering major changes in its commercial code, as well as accompanying changes in the tax code to facilitate corporate restructuring. This article attempts to summarise the changes being made to Japanese accounting standards, and the effects that they will have on Japanese management practices. The six areas of accounting reform are:

- the introduction of consolidated financial statements as a primary disclosure documents under the Japanese Securities and Exchange Law;
- the requirement of cashflow statement disclosure under the Securities and Exchange Law;
- the introduction of mark-to-market accounting for securities and real estate held for sale;
- the introduction of the recognition of deferred tax effect accounting;
- new rules for expensing research and development (R&D) costs; and
- the requirement to recognise unfunded pension liabilities.

The introduction of consolidated financial statements

Japan has had consolidated reporting since 1977, but the revision that came into effect with financial statements as of 31 March 2000 expands the scope of what is considered related company and makes the consolidated report the primary document under the Japanese Securities and Exchange Law reporting requirements.

The shift to consolidated reporting is expected to encourage managers to manage the corporate group to create value within the group, as opposed to shifting mistakes to subsidiaries to improve the parents' financial standing as was sometimes the case in the past.

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Under the new standards, the general rule is consolidation for companies if more than 50% of voting control is held, including attributed ownership. But even companies which are less than 40% owned may need to be consolidated, if the requisite control exists. For consolidation under the equity method, the general requirement is 20% to 50% of voting control.

But, if the requisite control is present, firms of which as little as 15% is owned may have to be reported in the related companies' financial statements under the equity method, where gains and losses are booked against a capital account and do not affect earnings. Even lower levels of ownership may necessitate consolidation in certain situations.

Consolidated accounting changes – along with revisions in the commercial code in 1997, which allowed the creation of holding companies, and a subsequent change in 1999 that allowed easier formation of holding companies by transferring shares – will help focus managers on creating value within their group of companies. This may create both a need and a method for divestiture of non/sub-performing assets and companies.

The introduction of consolidated financial statements, the removal of restrictions against holding companies, the introduction of stock-swaps, and spin-offs and split-offs will facilitate the creation of holding companies that help companies enter and exit new lines of business and expand overseas more easily. However, the tax structure that supports these corporate structures is still not in place.

Many companies are ready to take advantage of these new changes in the commercial code once the supporting tax legislation is enacted.

To enable managers to truly adopt a group focus, there needs to be a consolidated system of tax payment. It is now widely believed that consolidated tax returns will be introduced by April 2002, while changes that allow a company to spin off a business division to create a new company while not recognising any taxable gain are expected to come into effect by April of 2001.

Mark-to-market accounting

A statement of cash flows, akin to the disclosure required under US GAAP, is required of all companies subject to reporting under the Japanese Securities and Exchange Law from 31 March 2000. This requirement should prompt a number of Japanese managers to change their focus from increasing size and market share to a focus on whether individual projects will create an increase in the net present value (NPV) of their company. This shift towards a concern with cash flow has been accelerated by many Japanese companies' concerns with foreign credit ratings agencies and investors that concern themselves with the discounted value of a firm's future cash flows.

This increased focus on cash flow will also prompt managers to exercise stricter control over inventory, try to collect receivables faster and be more concerned about payment terms in contracts with their suppliers.

The introduction of mark-to-market accounting for securities and real estate held for sale from 1 April 2000 for operating companies will force businesses to recognise losses or gains inherent in these assets. Generally, assets are shown on a company's books at the price at which they were purchased at net of any depreciation in the case of buildings and fixtures on real estate. Carrying assets at cost on the books can create distortions when assets, which have a market value, have been depreciated to an unrealistic value from a market perspective or when assets have appreciated since being purchased. Distortions can also result in assets being held by a company at more than their market value in the case of assets that have appreciated or lost value since being purchased. In Japan, where both the stock market and real estate values have dropped dramatically over the past ten years, the revaluation of assets to fair market value could have a large impact. Additionally, many

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assets purchased before the mid-eighties often held large built in gains, which were then realised as needed to improve poor earnings numbers.

The introduction of mark-to-market accounting will primarily affect the valuation of securities and land held for sale, and from 1 April 2001, other securities, a category which includes the cross shareholdings that bind members of Japan's *Keiretsu* (a system whereby companies have cross-shareholdings, provide services and financial support to each other) and other business groupings.

Underperforming assets

Because both Japanese securities and real estate have been in a downward trend recently, companies may be compelled to sell underperforming securities and real estate assets. Increases and decreases in the value of securities and land held for sale that have ascertainable market value will be reflected in the income statement and will affect earnings. In contrast, the adjustments for increases or decreases in the market value of other securities will be a direct adjustment to owners' equity. In extreme cases, where there is a fall in value of more than 50%, with no foreseeable chance of recovery, an extraordinary loss, which affects earnings, must be recognised.

These valuation rules will force companies to dispose of land and securities that are not performing well. It will become harder for companies to hold shares merely to cement business relationships. The introduction of mark-to-market accounting, along with a general decline in share prices, has forced Japanese cross-share holdings to decline from more than half of all outstanding shares in 1995 to roughly 40% today. This unwinding of cross-share holdings is one element holding down share prices.

Shareholder value

In addition to promoting transparency by making it harder for management to smooth earnings using unrealised gain in securities held, the introduction of mark-to-market accounting for securities held for sale will promote a focus on the creation of shareholder value. Because companies will find it difficult to hold underperforming stocks, the management of underperforming companies will lose the stable block of shareholder votes that cross-share holdings represent. They will be forced to create value for normal shareholders, as opposed to creating some obscure value through other business dealings for those who hold cross-share holdings. This will eventually impose a market discipline on Japanese managers as a market for the control of management develops as more of a firm's shares become available for sale and shareholders increasingly demand return on their investments. This in turn should cause Japan to see growth in merger and acquisition (M&A) activity, both friendly and hostile.

The recognition of the effect of timing differences between financial accounting and tax reporting by the creation of deferred tax assets and deferred tax liabilities was introduced for financial statements as of 31 March 2000, for listed and non-listed companies capitalised at over ¥500m. A deferred tax asset is created when financial income is less than taxable income because of timing differences in the tax and financial reporting standards. A deferred tax liability is created when the financial income reported is more than the income as calculated under the tax laws.

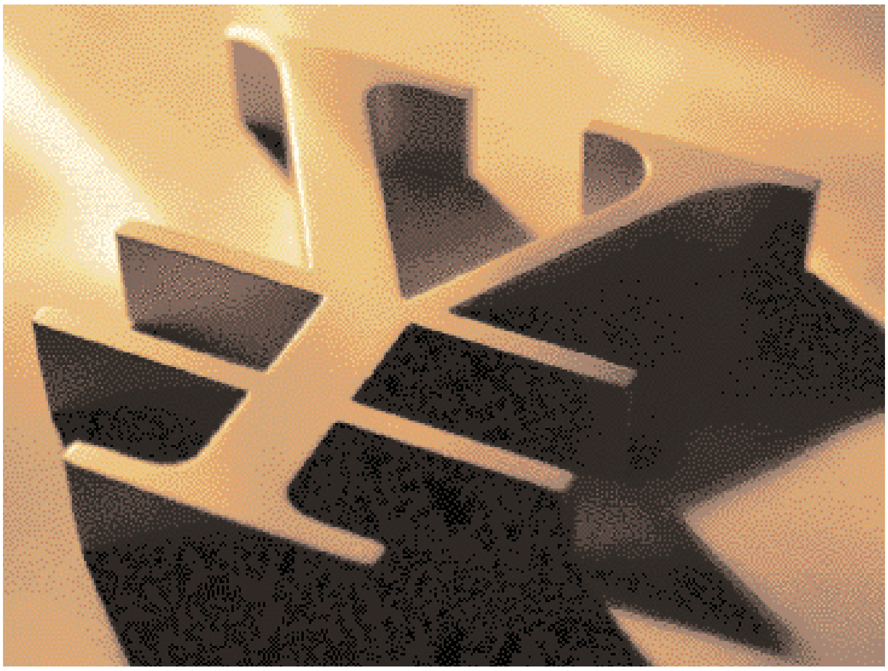
In practice, the introduction of tax effect accounting in Japan will likely result in a one-time increase in earnings. This is because in most cases the tax accounting adjustments to financial income result in the deferral of certain expenses for tax purposes. Some Japanese managers will use this increase in earnings corresponding to the introduction of tax effect accounting to liquidate non- or sub-performing assets before the introduction of mark-to-market accounting, as already discussed. This will allow the liquidation of disadvantageous positions while avoiding adverse impact to bottom line profit and earnings per share results.

In the past, R&D expenses were generally capitalised and expensed over a period of time. This had the effect of increasing reported earnings, but discouraged R&D since R&D expenditures were cash outlays, but could not be deducted immediately for tax purposes. The new rule allows R&D expenses to be deducted immediately for tax purposes. When companies can expense something, as opposed to capitalising it, it reduces the company's income by the amount of the expense in that year and so reduces its tax burden, while there is no effect to the company's cash flow. Therefore, in a way it is a tax incentive for R&D. This in turn should increase Japanese companies' competitiveness, because they are able to spend more on R&D with no impact to their net cash flow position, thanks to the tax subsidy of R&D caused by the reduction of tax burden allowed by the expensing R&D costs.

Disclosure

The requirements for Japanese companies to calculate and disclose their unfunded pension/retirement liabilities are complex and requires a costly adjustment. Japanese firms have historically underbooked reserves for retirement payments due to Japanese tax rules regarding the deductibility of retirement reserves, and have not been required to disclose potential pension liabilities in their financials. Under the new rules, Japanese companies will have to book the amount by which their projected benefit payments under all retirement plans exceed their plan's assets as a liability. Under the implementation rules, the pension liability must be charged to earnings over a period that must not exceed 15 years for financial accounting purposes. Some companies have chosen to effectively adopt the new rules early, recognising a loss in 1999.

The recognition of losses associated with companies' pension shortfalls will have a serious effect on the profitability of many Japanese companies leading up to the introduction of the new pension/retirement rules on 31 March 2001 for listed and non-listed companies capitalised at more than ¥500m.



Write-offs in 1999 were projected to wipe out 16% of the pre-tax earnings of listed companies in Japan. The depth of the problem remaining to be addressed can be seen by the fact that in December of 1999 the total unrecorded pension liabilities of companies listed on the first section of the Tokyo Stock Exchange (TSE) were estimated to be ¥81trn, while the total market capitalisation of the TSE first section was ¥460trn. Complications were compounded by a 1998 tax law change, which lowered the amount of retirement reserves allowed to be expensed by corporations for lump sum retirement payments.

While healthy companies have begun to book losses to cover pension/retirement shortfalls ahead of the implementation of the new legislation, many weaker firms may not be able to do so. This will either cause an increase in business failures or in M&A activity as stronger organisations make strategic purchases of companies with strong core businesses that cannot provide for their pension liabilities.

Issues that still need to be resolved

Japan is already taking steps to move closer to international accounting standards with the introduction of new accounting rules. However, there are still remaining issues that make Japanese financials unique, and sometimes it is the things that look the most familiar which can be the most deceptive. For example, with the introduction of consolidated accounting as the primary presentation method under the Japanese Securities and Exchange Law, you will now see an account on the balance sheet for minority interest. This shows what portion of a firm's equity belongs to someone else, and is familiar to most accountants who have trained in the west. In Japan, analysts do not consider a minority interest as equity of majority shareholders. In the US, it is treated as equity for analysis purposes. This means that when you see a ROE calculation (or any ratio involving equity) in Japan, generally the denominator will be smaller than it would be in the US calculation by the amount of the minority interest. That in turn improves the ROE relative to a US company.

Japan's recent accounting changes should make Japanese companies' financials more consistent with other international companies and thus better accessible to those trained in western accounting.

Additionally, all of the changes should bode well for investors in Japan's capital markets in the long term by providing increased transparency in reporting and by forcing management to pay more attention to the creation of shareholder value. In addition, during the transition period, there will likely be many opportunities for both foreign and domestic companies to make strategic acquisitions in the Japanese market. ■

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