Convergence between IFRS and Japanese GAAP

Yoshio Fujikawa

ABSTRACT

Recently more than 100 countries adopted IFRS as their national accounting standard, and only the U.S. and Japan are trying to keep their own accounting standard in major countries. The EU's equivalence test against US GAAP and Japanese GAAP accelerates the convergen ge talk among three accounting setters: FASB, IASB and ASBJ. Even in Japan, many experts are insisting that Japan should adopt IFRS, instead of keeping their own accounting standards but ASBJ does not. The convergence is to exchange various and original opinions with outside parties and to get the best ideas in the existing systems. When the convergence is on agenda based on different accounting principles, it must be discussed from the foundation of idea, that is, the conceptual framework. Even after some agreement on the convergence, it will be endless work for accounting setters since the new economic transaction will be born in the future, in which a new accounting standard will be required. Especially, the different economic circumstances in each country will often offer different problem.

Keyword: convergence, IFRS, Japanese GAAP, Conceptual Framework

1. Progress of Accounting Convergence

As corporate activities have expanded internationally, and as the capital markets have been becoming borderless, companies or investors can now select the market with the best conditions to raise or invest funds wherever they wish to. As a result, the accounting comes to require more transparency and comparability as part of business infrastructure. Under the circumstance, The IASB (the International Accounting Scand-
ards Board) is founded to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards in 2001. It has been working to achieve the global convergence of accounting standards, as national accounting standards are being converged with one another. While the consistency in their application is not confirmed, IFRSs is used, mandatorily or optionally, in many countries, their national standards are converging with IFRSs.

These trends were embodied by IOSCO (the International Organization of Securities Commissions) that announced the support of the International Accounting Standards (IAS) as the accounting standards to be applied in multinational fund raising in 2000. As a result, IAS began to be recognized internationally as the actual standards that are applied to the corporations. In 2002, the EC prescribed the application of International Financial Reporting Standards (IFRS) in their market. Encouraged by adoption of IFRS in the EU, IASB accelerated the international convergence in accounting.

The use of IFRS continues to enhance globally. According to the pub-

1) International Organization of Securities Commissions (IOSCO) is recognized as the international standard setter for securities markets and is the world's most important international cooperative forum for securities regulatory agencies to establish standards and an effective surveillance of international securities transactions.

2) IAS was set by the International Accounting Standards Committee (IASC). It was formed in 1973 through an agreement made by professional accounting bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States of Americas. Accounting standards were set by a part-time, volunteer IASC Board that had 13 country members and up to 3 additional organizational members. In 1997 IASC concluded that they must find a way to bring about convergence between national accounting standards and practices and high-quality global accounting standards. To do that, IASC saw a need to change its structure. On 1 April 2001, the new IASB took over from the IASC the responsibility for setting International Accounting Standards which are called as International Financial Reporting Standards (IFRS).

Referred from the web page of the Debitte Tosehe Tsunamitsu.
http://www.isop100.com/extract/extract.htm
lic lecture by Sir D. Tweedie on 7th March 2007, they are required for all domestic companies in 75 countries and permitted in 23 countries in 2006. And they are expected to expand to 150 countries in 2011. These countries include China (from 2007), Canada (from 2011), Korea (from 2011), or Russia. IFRS has been matured through the use by the companies in a range of countries for a number of financial years.

The United States is one of the exceptional countries. Since the United States is the leading country to develop the accounting standards and it has the biggest and advanced capital market in the world, it is quite reasonable to keep its own accounting standards and continue to develop it. Under the circumstance, the major concern of IASB is whether the United States will accept the reporting based on IFRS. FASB (US Financial Accounting Standards Board) and IASB (International Accounting Standards Board) have been pursuing the convergence talk since "Norwalk Agreement" in 2002. February 2006 renewed commitment toward the convergence was announced in the form of the Memorandum of Understandings (MCU), which specified a set of items for which either the convergence or the measurable progress is to be achieved by 2008. This means there will be a possibility that the U.S. may accept the accounting standards other than US GAAP without reconciliation for the first time. So far the company listed in the U.S. market must prepare the financial report under US GAAP. U.S. suggested the premise to accept accounting principles other than US GAAP as follows:

1) Accounting principles concerned are of high quality and comprehensive
2) Consistent in interpretation and application

3) The Ken Spencer Memorial Lecture at University of Melbourne.
   "Keep it simple stupid!" Can global standards be principle-based?
3) widely used in the U.S. market

IFRSs are satisfying first and third items but the second one is still under progress even in the EU market.

Japan is also exceptional country which is trying to keep its original accounting system and seeking international convergence without adopting IFRS. Japan has one of the greatest capital market in the world and is in a position of exerting enormous global influence instead of simply adopting IFRS. The ASEJ (Accounting Standards Board of Japan) also started in March 2005 the discussion with the IASB toward the convergence of the two standards, and agreed at their third meeting in March 2006 to accelerate the process. Furthermore, the ASEJ embarked on similar discussion with the FASB in May 2006.

Accounting principles in each country have been developed and formulated under the effect of their domestic industrial structure, business environments, legal systems, financial systems, cultures, history or political environments. For the countries that the capital market or economic systems are not matured, it would be easier, better and less cost to adopt the external IFRS rather than to develop their own accounting standards. However, for the well developed countries like U.S. or Japan, it is some time unbeneificial to be forced to use the external accounting standards which do not reflect the social or economic environment.

2. EU’s assessment of equivalence between the third countries’ GAAP and IFRS/IAS

After EU adopted regulation 1606/2002 to decide IAS/IFRS as accounting standards in their market, third country issuers will be required to prepare and present financial statements on the basis of IAS/IFRS or the third country’s national accounting standards if these
standards are equivalent to IAS/IFRS. EU requested the Committee of European Securities Regulators (CESR) to make a technical advice whether accounting standard in the third countries outside EU, which are U.S., Canada and Japan, are equivalent to IAS/IFRS (June 25th 2004). Non-EU companies listed in EU can submit a financial report by their domestic accounting standards so far, but it may not be accepted if the accounting standards are regarded as not equivalent to IAS/IFRS from 1st January 2009.

In 2005, CESR published the “technical Advice on Equivalence of Certain Country GAAP and on Description of Certain Countries Mechanisms of Enforcement of Financial Information.” in which The CESR deemed Japanese GAAP to be equivalent to IFRS but proposed 26 remedies for the significant differences between IFRS and Japanese GAAP. These remedies include following Proforma Balance Sheet and Profit and Loss account as a Supplementary Statements.

— Consolidations for subsidiaries such as Special Purpose Entities (SPEs)
— mergers by purchasing method rather than the pooling of interest method which is accepted only in Japan
— Unified accounting policy for foreign subsidiaries

Furthermore, additional disclosures are requested as a descriptive nature and a quantitative nature in two categories.

Disclosures A: Additional narrative and/or quantitative disclosures augmenting the disclosures already provided pursuant to third country GAAP.

Disclosures B: Quantitative indication of the impact of an event or transaction, had this event or transaction been accounted for following

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4) Originally it was scheduled on 1st January 2005. It was postponed twice, once to the same date of 2007, and then rescheduled to the current one. In Japan, this was acknowledged as “2005 Problem” initially, and now it is referred as “2009 Problem”.
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Differences between Japanese GAAP and IAS/IFRS

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IAS/IFRS provisions.

CESR said that this was not an evaluation or assessment of the progress in convergence as of the issued date, but rather, a collection of the

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§) Future standard ED3 Japanese GAAP will be Disclosure A.
facts available from public sources. Secondly, in relation to the definition of equivalence, CESR provides a definition (in line with that set out its advice to the European Commission in June 2005 Ref.CESR/05-230b) i.e., that the criteria for deciding equivalence should be that investors could make a similar decision irrespective of whether they are provided with financial statements based on IFRS or on third country GAAP.

CESR also considers that a determination that the third country GAAP is equivalent to IFRS, must also be based on the presumption that filters at country level, audit assurance and enforcement on entity levels are sufficient for investors to rely on. CESR supports the Commission’s view that it should publish the basis upon which it will assess equivalence as soon as possible and by 1 July 2008.

Against this advice, some comments are released from public or private organizations such as ASBJ, JICPA, Financial Service Agency or Business Accounting Council (BAC). The comments from them similarly appreciate that CESR regarded Japanese GAAP as equivalent to IFRS, but they strongly requested that the remedies should be limited to the necessary minimum level. Financial Services Agency Government Japan said it would be a big burden for Japanese companies to prepare the reconciliation or proforma financial report, and it might become the high hurdle to be listed in the EU market. ASBJ insisted that Japanese GAAP has reached a level of high-quality, internationally recognized accounting standards.

ASBJ and respective project teams are working very hard to eliminate

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6) The Business Accounting Council (BAC) was founded as a Japanese GAAP setter as an advisory body to the Minister of Finance (MOF). After restructuring the government, the BAC is now an advisory body to the Prime Minister of Japan and the Commissioner of Financial Services Agency (FSA). More specific missions of the BAC include establishing accounting and audit standards and recommending strategic plans for domestic and international activities.
or reduce the difference between two standards but among them, one of the major differences is accounting for business combinations. Japanese GAAP requires entities that either the purchase method or the pooling-of-interest method be applied depending on the economic substance of such transactions. If a business combination is judged as “uniting of interest” as a result of applying the specific criteria, the pooling-of-interest method should be applied; otherwise, the transaction is deemed as “acquisition of other entity,” to which the purchase method should be applied. Moreover, any goodwill recognized as a result of applying the purchase method should be amortized over no more than 20 years. It will be hard to negotiate about this problem.

3. Developing accounting standards and Conceptual Framework in Japan

In Japan, international harmonization of accounting standards has been promoted rapidly through the Accounting Big Bang since 1996.

Japanese accounting standards have undergone significant improvement particularly since the late 1990s, in line with the global developments in accounting standards, aimed at providing investors with an enhanced set of information. Within a short period of time, new sets of standards (e.g., those for consolidation, financial instruments, post-retirement benefits, impairments of fixed-assets, and business combinations) have been formulated, and today, Japanese accounting standards can be considered as of high quality compared with US GAAP or IFRS. Besides, they are, taken as a whole, consistent with global accounting standards, albeit some differences.

Most of above-mentioned accounting standards were prepared and announced by the BAC (the Business Accounting Council), the former and public sector standard sette. In August 2001, a new accounting
standard-setting body was formed in the private sector. The Financial Accounting Standards Foundation (FASF) is a supervisory foundation, and, as an independent force, the Accounting Standards Board of Japan (ASBJ) is now working on developing the Japanese GAAP. BAC will no longer add a new project for pursuing setting accounting standards after they issued accounting standards for business combination in October 2003.

The purpose of the establishment of the ASBJ is to develop domestic accounting standards in its own independent decision making, through a distillation process of experience in financial markets and accounting community. It also includes contributing to international harmonization or convergence of accounting standards.

The convergence is to exchange various and original opinions with outside and to get the best ideas in the existing systems one another. When the convergence is on agenda based on different accounting principles, it must be discussed from the foundation of idea, that is, the conceptual framework.

In Japan, Discussion Paper, Conceptual Framework of Financial Accounting was released on 2004. After reflecting the opinions from various entities, including overseas standard setters, ASBJ issued revised one on December 2006.

One of the expected roles of Discussion Paper is that it enhances communication with standard-setters in the world. It has contents similar to IASB/FASB conceptual framework, so as to make it easy to deliberate common interests in financial accounting; objectives of financial reporting; characteristics of accounting information; elements of financial

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statements; and recognition and measurement in financial statements.

Discussion Paper is still an exposure document, because the IASB and the FASB are now reviewing their concept statements toward setting a common set of framework and the ASBJ intends to continue its discussion on the conceptual issues.

**Objectives of Financial Reporting**

Discussion Paper on conceptual framework describes the objectives of financial reporting in chapter 1. Similar to the other conceptual frameworks, Discussion Paper states that the objectives of financial reporting is to provide the useful information for decision making by investors and other financial statement users. More specifically, Discussion Paper says that the information should be focused on an entity's financial positions and performance. It also emphasizes that earnings is important to communicate with users the entity's past performance, so that users can establish their own prospects for the entity's future performance and, therefore, the entity's firm value.

Discussion Paper states that the principal role of financial reporting is to provide information about the entity's financial history rather than the prospect in future. Based on such information, investors make their own investment decision at their own risk.

**Qualitative Characteristics of Accounting Information**

Chapter 2 of Discussion Paper addresses qualitative characteristics of accounting information. It identifies qualitative characteristics that make information useful for users' decision making. Decision Usefulness is supported by two fundamental characteristics: relevance and reliability.

On the other hand, decision usefulness should be achieved in consideration for comparability and internal consistency. Those two character-
istics are regarded as restrictive constraints in reaching for decision usefulness. Internal consistency is defined as a quality in which information is consistent with the existing fundamental concepts underlying accounting standards and practices. This will be a unique concept which is presented only in Japanese Conceptual Framework.

**Elements of Financial Statements**

Chapter 3 of ASBJ’s Discussion Paper addresses issues related to elements of financial statements. It identifies the following elements: assets; liabilities; net assets; shareholders’ equity; revenue; expense; comprehensive income; and net income.

It may be strange why Discussion Paper identifies similar two elements of net assets and shareholders’ equity. Net assets are defined as the excess of assets over liabilities, while shareholders’ equity is defined as shareholders’ interest in claims to assets. Difference between net assets and shareholders’ equity includes changes in fair value of certain financial instruments, translation adjustments, minority interest, and stock options. Comprehensive income and net income are identified as separate elements of financial statements. Comprehensive income is defined as changes in net assets during the period from non-owner transactions. Net income is the excess of revenue over expense, as recognized based on the concept of “release from risk,” which seems to be another expression of realization or matching.

**4. Convergence in future**

It seems that ASBJ strains to keep Japanese accounting standards and reluctant to converge with IFRSs. But their basic stance is that true convergence should be made through the evaluation and/or choice by the participants of capital markets where there are some different in each market after those differences are reduced as much as possible.
The convergence of accounting standards among IFRS, US GAAP and Japanese GAAP is to eliminate reconciliation requirements among these standards.

The difference between convergence and adoption is a difference of process to the goal of having a single set of high quality accounting standards, not a difference of the goal itself.

On August 8 2007, the ASBJ and the IASB announced Tokyo Agreement on achieving convergence of accounting standards by 2011. They will accelerate convergence and eliminate by 2008 major differences between Japanese GAAP and IFRSs with remaining differences being removed on or before 30 June 2011.

Mr. Ikuo Nishikawa, the chairman of ASBJ commented that this agreement will enable Japanese companies to publish financial statements prepared under Japanese accounting standards without any remedies continuously in the EU and other capital markets using IFRSs.

We would like to express respect to the concerned people's effort. However, the convergence will be endless work for both IASB and ASBJ since the new economic transaction will be born successfully in the future, which new accounting standard will be required. Especially, the different economic circumstances in each country will offer the different problem.

*本稿は、京都学芸大学総合研究所の助成（2006年度在外研究）による研究成果の一部である。

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