THE JAPANESE ACCOUNTING REVIEW
VOLUME 1
2011

Some Thoughts on Accounting Research in Japanese Settings

ROBERT E. VERRECCHIA*
The Wharton School
UNIVERSITY OF PENNSYLVANIA

CLARE WANG
Kellogg School of Management
NORTHWESTERN UNIVERSITY

ABSTRACT

As the first English publication focusing on Japanese accounting research, we believe that one of the long-term goals for this journal is to help build an indigenous research culture that attracts an international audience. In this paper, we provide some thoughts on 1) identifying Japanese settings that may offer unique advantages and merit specific analysis; and 2) the ongoing convergence to International Financial Reporting Standards (IFRS).

1. General Research Issues That Can Be Addressed with Japanese Settings

One unique advantage of Japanese accounting research is the opportunity to use Japanese settings and data to address research issues of interests to an international audience that would be difficult or impossible to test otherwise. In these natural settings, participants face real economic incentives; therefore, consequences and their actions can be observed over time. In addition, knowledge of the local institutional environment is crucial for making research design choices and correctly interpreting the results. In this section, we discuss as examples two distinctive disclosure features in Japan that one might exploit to address research issues of general interest.

Most academic research on management forecasts has been conducted on U.S. firms; here researchers place a considerable amount of emphasis on self-selection issues associated with providing voluntary management forecasts.[1] One distinctive disclosure feature in Japan is that the Japanese Securities and Exchange Law requests that firms disclose publicly annual management forecasts of key accounting figures. Consequently, management forecasts of the upcoming year's sales, net income and dividends are announced simultaneously with last period's actual accounting data in annual and semiannual press releases. This unique practice in Japan makes it possible to conduct large-scale, powerful studies on management forecasts over an extended period of time, and enables researchers to address interesting, unresolved questions in the extant literature.

For example, when management forecasts assume a role that approximates mandatory

* Corresponding Author. *Address* University of Pennsylvania 1322 Steinberg Hall-Dietrich Hall, 3620 Locust Walk, Philadelphia, PA 19104-6365, USA.
Telephone (215) 898-6976 *E-mail* verrecch@wharton.upenn.edu

[1] See Hirst, Koonce and Venkataraman (2008) for an extensive review.

disclosure, how do they interact with other sources of information such as analyst forecasts? Are they complements or substitutes? Are they more informative? If (and when) do managers have the incentive to bias the forecasts? Heinle and Verrecchia (2011) investigate a variety of factors that affect management forecast bias, both under a situation where all firms are required to disclose and a situation where only some firms choose to disclose. The Japanese data, combined with the U.S. data, enable researchers to conduct empirical tests for the different predictions in the model. The long time-series management forecasts data also allow researchers to examine the iterative nature of management forecasts - that is, managers may establish a certain forecast style (Yang, 2011). Finally, an additional empirical advantage is that management forecasts data provide a direct measure of management's expected future performance rather than requiring a proxy to be generated for these expectations.[2]

The second distinctive disclosure feature is the channel and level of communication between managers and shareholders in Japan, particularly for firms belonging to an industrial grouping (i.e., keiretsu). Dewenter and Warther (1998) make reference to the "complex web" of interactions that generate a free, constant, and heavy flow of information between the firm and its major shareholders.[3] Consequently, the basic assumption that underlies a U.S. setting that the level of adverse selection between managers and shareholders is severe may not be as pervasive for Japanese firms in general, and keiretsu firms in particular. At the same time, the information asymmetry between different classes of investors may be more pronounced in Japan as the major shareholders have direct, private access to "insider information" regarding the firm's performance and opportunities. Several interesting disclosure-related questions arise from this unique institutional feature.

First, how does the private information channel affect the quantity and quality of public disclosure? On the one hand, information sharing with major shareholders may reduce the managers' incentives to provide information to the market, suggesting that keiretsu firms disclose less information than other firms. Others argue, however, that the keiretsu corporate structures may promote better public disclosure due to the high level of monitoring provided within the corporate grouping.

Second, what is the effect of selective disclosure on the local capital market? Are these effects desirable? Why isn't a disclosure regulation similar to Regulation Fair Disclosure in the U.S. promulgated in Japan to level the playing field for all investors? Assuming this is an economy-wide equilibrium outcome, do researchers need to develop separate disclosure theories for countries where the financial reporting environment was developed to suit the needs of stakeholders other than public investors?

Third, recent theoretical studies provide new insight on when information asymmetry plays a role in equity markets (Lambert, Leuz and Verrecchia 2011; Lambert and Verrecchia 2010). When equity markets are perfectly competitive, information asymmetry has no separate effect on the cost of capital. When markets are imperfect, information asymmetry can have a separate effect on firms' cost of capital. Two empirical studies provide some evidence consistent with the theory using U.S. data.[4] It would be an interesting extension to test whether or not the insight offered in these theoretical studies also applies outside of the U.S. Japan is a good choice because of its market size and depth. In addition, the more pronounced information asymmetry amongst shareholders and differences in

---

[2] For example, Herrmann, Inoue and Thomas (2003) leverage the management forecasts data to investigate Japanese managers' use of income from the sale of fixed assets and marketable securities to manage earnings.

[3] Dewenter and Warther (1998) emphasize this feature to test competing theories on firm's dividend behavior.

[4] See Armstrong, Core, Taylor and Verrecchia (2011) and Akins, Ng and Verdi (2011).

market competition in Japan provide a potent treatment effect.

2. Convergence to IFRS

Japan has taken major steps towards mandatory IFRS adoption for all Japanese listed firms by 2016. The Minister of Financial Services announced in June 2011, however, that mandatory IFRS adoption will be postponed. We believe there are many research opportunities as future decisions unfold. First, accounting standards in Japan have been developed extensively over the last 10-15 years, and based on the "Tokyo Agreement," most of the accounting differences should have been eliminated by now.[5] Under these conditions, what were the concerns of the various constituents over mandatory adoption? Second, the extant literature highlights that seemingly similar accounting rules can be implemented very differently. For example, Skinner (2008) shows that, at least with respect to deferred taxes, the Japanese adoption of rules that on the surface appear similar to those in other regimes does not necessarily result in the equivalence of accounting practice. Based on this evidence, what are the most important institutional impediments? Are the impediments simply transition problems that will diminish, or are they deep-rooted and will remain without intervention? Finally, the use of IFRS was introduced on a purely voluntary basis in March 2010. Researchers can begin to learn from Japanese firms' voluntary adoption behavior, which should provide some initial evidence on the cost-benefit trade-off for IFRS adoption.

REFERENCES

Armstrong, C. S., J. E. Core, D. J. Taylor, and R. E. Verrecchia. 2011. When does information asymmetry affect the cost of capital? *Journal of Accounting Research* 49 (March): 1-40.

Akins, B., J. Ng, and R. S. Verdi. 2011. Investor competition over information and the pricing of information asymmetry. *The Accounting Review*, forthcoming.

Dewenter, K. L., and V. A. Warther. 1998. Dividends, asymmetric information, and agency conflicts: Evidence from a comparison of the dividend policies of Japanese and U.S. firms. *The Journal of Finance* 53 (June): 879-904.

Herrmann, D., T. Inoue, and W. B. Thomas. 2003. The sale of assets to manage earnings in Japan. *Journal of Accounting Research* 41 (March): 89-108.

Heinle, M. S., and R. E. Verrecchia. 2011. Management forecast bias. *Working Paper*, University of Pennsylvania.

Hirst, D., L. Koonce, and S. Venkataraman. 2008. Management earnings forecasts: A review and framework. *Working Paper*, University of Texas.

Lambert, R. A., C. Leuz, and R. E. Verrecchia. 2011. Information asymmetry, information precision, and the cost of capital. *Review of Finance*, forthcoming.

Lambert, R. A., and R. E. Verrecchia. 2010. Cost of capital in imperfect competition settings. *Working Paper*, University of Pennsylvania.

Skinner, D. J. 2008. The rise of deferred tax assets in Japan: The role of deferred tax accounting in the Japanese banking crisis. *Journal of Accounting and Economics* 46 (December): 218-239.

Yang, H. I. 2011. Capital market consequences of managers' voluntary disclosure styles. *Journal of Accounting and Economics,* forthcoming.

[5] In August 2007, the Accounting Standards Board of Japan and the International Accounting Standards Board reached the "Tokyo Agreement"; under this agreement 26 major differences between Japanese GAAP and IFRS would be eliminated by the end of 2008, with the remaining differences being removed by June 2011.