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The Complex Equilibrium Paths towards International Financial Reporting Standards (IFRS) and the Anglo-American Model: The Case of Japan*

NORIYUKI TSUNOGAYA†
Department of International Economy and Business
KYUSHU UNIVERSITY

PARMOD CHAND
Department of Accounting and Corporate Governance
MACQUARIE UNIVERSITY

ABSTRACT

We adopt the accounting ecology framework of Gernon and Wallace (1995) to investigate the unique Japanese process of accounting reforms and convergence. The uniqueness of the Japanese accounting framework is primarily the result of the integration of the Japanese traditional accounting system and its surrounding infrastructures with International Financial Reporting Standards (IFRS), the Anglo-American model, and the liberal market economies (LMEs). The objective of this study is to demonstrate that accounting as the language of business is deeply embedded in the historical, legal, business and economic environments of each country and that these contextual factors cannot be ignored in the process of significant accounting reforms, including accounting convergence. The paper provides evidence that even in the process of global accounting convergence countries are not achieving *de facto* convergence because optimal mechanisms of the accounting system and its surrounding infrastructures are contextual and embedded in the accounting ecology of each country.

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Key Words: Global Convergence of Financial Reporting; International Financial Reporting Standards (IFRS); Japanese Accounting System

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† Corresponding Author. *Address* Kyushu University 6-19-1 Hakozaki, Higashi-ku, Fukuoka, 812-8581, JAPAN.
Telephone +81(92)642-2473 *E-mail* tsuno@en.kyushu-u.ac.jp

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1. Introduction

The International Accounting Standards Board (IASB) and other national standard setting bodies seek to achieve a high quality financial reporting system and more than one hundred twenty countries appear to have adopted International Financial Reporting Standards (IFRS) to improve their accounting practices. The arguments in favor of global convergence of financial reporting include achieving similarity in both accounting standards (*de jure*) and accounting practices (*de facto*). However, developing financial reporting standards seems easier than addressing controversial issues in each country adopting IFRS such as differences in the regulatory environment, business practices, language, culture and the judgment of accountants (Doupnik and Richter 2003, 2004; Ball 2006; Doupnik and Riccio 2006; Patel 2006). We argue that a research topic concerning the global convergence of financial reporting must take into consideration local contexts such as the accounting ecology of each country, particularly when examining *de facto* convergence.

In adopting IFRS the consideration of local context is more important in non- Anglo-American countries. This is because IFRS have been developed in accordance with Anglo-American values, practices, and principles (Hellmann et al. 2010). The Anglo-American model, which has been adopted in countries such as the U.K. and the U.S., has developed over a long period of time in an environment characterized by investor orientation, common law, separation of accounting and tax schemes (i.e. double-reporting regime), and extensive application of professional judgments. In contrast, the Continental-European model, which has been adopted in countries such as France, Germany, and Japan, is characterized by creditor orientation, code law, interdependence of accounting and tax schemes (i.e. single-reporting regime), and weak accounting profession (Nobes 1992; Doupnik and Perera 2012; Nobes and Parker 2012).

Furthermore, economies can be of two types, namely the "Liberal Market Economies (LMEs)" such as those that are evident mainly in Anglo-American countries, and the "Coordinated Market Economies (CMEs)" that exist mainly in Continental-European countries. In the LMEs, competition through challenges in the marketplace is encouraged. In contrast, long-term cooperative relationships between firms and banks, between different firms, and between firms and the labor force are fostered in the CMEs (Franks and Mayer 1997; Kaplan 1997; Schmidt and Spindler 2002, 2006; Leuz and Wüstemann 2003; Schmidt and Tyrell 2004; Hackethal et al. 2005).

Countries converging towards IFRS can adopt either of the two convergence approaches. One is the "direct adoption approach" in which IFRS are adopted as domestic standards while the other is the "cautious convergence approach" in which domestic standards are applied and the disparities between IFRS and domestic standards are consistently reduced over a period of time. It is important to note that Japan has adopted the cautious convergence approach. Indeed, Japan is currently undergoing a controversial and complex process to reduce disparities in financial reporting and other infrastructures to align the entire system with IFRS, the Anglo-American model, and the LMEs.

A number of prior studies have examined various issues concerning financial reporting systems in Japan (Arai and Shiratori 1991; Cooke 1991; Nobes 1991; McKinnon 1994; Hamamoto 1995; Hiramatsu 1998; Chiba 2001; Kikuya 2001; Benston et al. 2006; Koga and Rimmel 2007; Kaneko and Tarca 2008). While previous research provided valuable insights, the topics relating to the Japanese contextual factors such as historical, legal, business, economic, and accounting environments, and the relevant infrastructures such as financial, governance, and employment systems have been largely ignored. We adopt the accounting ecology framework of Gernon and

Wallace (1995) to investigate the unique Japanese process of reforms and convergence.[1] The uniqueness of the Japanese accounting framework is primarily the result of the integration of the Japanese traditional accounting system and its surrounding infrastructures with IFRS, the Anglo-American model, and the LMEs. The objective is to demonstrate that accounting as the language of business is deeply embedded in the historical, legal, business and economic environments of each country and that these contextual factors cannot be ignored in the process of significant accounting reforms, including accounting convergence.

We provide evidence that the unique Japanese process of accounting convergence originates in various factors. Unlike other countries that have just adopted IFRS, Japan has prepared a complete set of accounting standards, auditing standards, and conceptual frameworks to compete with IFRS and International Standards on Auditing (ISA). These standards have been prepared by the Japanese standards-setting bodies, namely the Business Accounting (Deliberation) Council (BAC) and the Accounting Standards Board of Japan (ASBJ). The Japanese CME also has well-organized infrastructures, which include one of the largest capital markets in the world, namely the Tokyo stock exchange, stable financial systems, modernized governance structures, and systemically-combined laws and ordinances. Therefore, Japan has recognized that it would be futile to adopt IFRS without reforming these and related facilities and resources.

The remainder of this paper is organized as follows. Section two briefly outlines the accounting ecology framework developed by Gernon and Wallace (1995). Using some aspects of this framework, section three outlines the historical, legal, and business environment of Japan. Section four describes the Japanese-specific process towards accounting convergence and section five analyzes the immediate pressures and conflicts between the cautious Japanese convergence approach and intrusive events such as the strategies of the European Union (EU) and the U.S. Securities and Exchange Commission (SEC). Section six investigates recent significant reforms in Japan such as disclosure, financial, governance, and employment systems. The last section concludes this paper by summarizing the unique Japanese process of accounting convergence.

2. The Accounting Ecology Framework

The accounting ecology framework developed by Gernon and Wallace (1995) describes five "slices" within the framework: social, organizational, professional, individual, and accounting, to provide a holistic analysis of the accounting environment in each country. Gernon and Wallace (1995) focused on the synthesis and interrelationships of these factors because they influence and are influenced by the accounting environment in each country.

The five slices of the accounting ecology framework can be defined as follows. First, the social slice refers to structural, demographic, and cultural elements that may affect the demand for financial accounting services. Second, the organizational slice encompasses such elements as organizational size, technology, complexity, culture, and human and capital resources that may affect rationalization of the choice and design of accounting systems. Third, the professional slice refers to the education, training, registration, discipline, and ethics of accountants and auditors. Fourth, the individual slice refers to accounting policy choices made by individuals and covers the total setting in which

[1] Gernon and Wallace (1995) used the term 'accounting ecology' to describe the specific environment in which accounting operates in each country.

reporting enterprises, professionals, and other individuals lobby standard setters to pursue their self-interests. Finally, the accounting slice refers to accounting practices, rules and/or trends that affect or are affected by the other slices of the environment (Gernon and Wallace 1995, p.60).

Prior studies have also used the accounting ecology framework to analyze the accounting practices of various countries. For example, Heidhues and Patel (2011) applied this accounting ecology framework and suggested that international accounting research may be further enhanced by taking into account contextual factors such as political, legal, social, and historical factors. In particular, they applied this framework to provide additional insights into the factors that differentiate the German accounting model from other accounting models, such as the conservative nature of accounting practices and the importance of merchants' privacy in Germany. This framework is also applied by Perera and Baydoun (2007), Baker et al. (2010), and Hellmann et al. (2010) to clarify the unique features of accounting systems in Indonesia, China, and Germany respectively. Based on the accounting ecology framework developed by Gernon and Wallace (1995), the following sections provide a detailed analysis of the historical, legal, business and economic environment in Japan.

3. Aspects of the Japanese Accounting Ecology

3.1 Historical Environment: The Influence of Germany and the U.S.

The Japanese accounting system has been primarily influenced by the German and the U.S. accounting systems since World War II. Specifically, the Japanese Commercial Code was enacted in 1890 after the opening of Japan to foreign countries in the Meiji Era (1868-1912) based on a draft prepared by a German scholar, K. F. H. Roesler (Arai and Shiratori 1991; Benston et al. 2006). Because the Commercial Code regulated measurement practices in Japan, the German influence largely determined the accounting environment in Japan. Under this Japanese Commercial Code, creditor protection and the reconciliation of interests among stakeholders were achieved by conservative measurement rules such as a less than market price basis (Fujita 1966; Iino 1967).

Significant changes in the accounting environment of Japan resulted from the U.S. occupation after World War II. The General Headquarters of the Allied Forces dissolved powerful family-controlled holding companies (called *zaibatsu*) to establish a democratic Japanese economy and accelerated the improvement of the corporate reporting system in Japan (McKinnon 1986). The implantation of the U.S. Accounting system was based on the complete overhaul of the Japanese accounting system, which included the establishment of the Japanese SEC in 1948, the Certified Public Accountants Act in 1948, and the Investigation Committee on Business Accounting Systems (ICBAS) in 1948 (Fujita 1981; Someya 1989; Chiba 2001).

The Japanese Securities and Exchange Law established in 1948 was modeled after the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934. The primary focus of this law is to provide useful information for investment decision-making by shareholders and other investors (Arai and Shiratori 1991). Additionally, among seven general principles of *A Statement of Business Accounting Principles (Kigyo Kaikei Gensoku)*, which was released in 1949, the "principle of unity" demanded 'one and the same' accounting numbers even for different reporting purposes such as financial reporting, submission to a general meeting of shareholders, credit guarantee, and calculation of taxable income purposes. Although this statement was patterned after the U.S. accounting principles, the ICBAS did not adopt it unquestioningly but arranged it so that this statement would cover the specific demands within Japan to reform the Japanese accounting system simultaneously and complementarily. Importantly, the principle of unity played a significant role until 1980s in improving the three accounting-related laws, namely the Securities and Exchange Law, the Commercial Code, and the Corporation Tax Law (Ando 2010).

3.2 Legal Environment: The Triangular Legal System

The Japanese Commercial Code and the Japanese Securities and Exchange Law had both German and U.S. influences. These laws had some similarity because in both, the prudent and conservative nature of measurement bases was adopted. Furthermore, with the revision of the Commercial Code in 1981, the principle of unity was substantially achieved, and the reciprocating move to reduce disparities in accounting rules between these laws was mostly achieved (Ando 2010). In addition to the principle of unity, the Financial Instruments and Exchange Act (enacted in 2006 as a full revision to the Securities and Exchange Law), the Companies Act (enacted in 2005 as a full revision to the Commercial Code), and the Corporation Tax Law (enacted in 1947) have influenced accounting practices in Japan. Because these three laws are connected systemically to one another, this unique style of accounting regulation is called the "triangular legal system".

Each of the regulations in the triangular legal system plays an important role. The objective of the Financial Instruments and Exchange Act is to support the strong development of the national economy by providing useful information for investors (Article 1). The purpose of the Companies Act is to reconcile the interests of stakeholders and to protect creditors. To achieve this objective, this law prescribes the maximum amount of surplus available for distribution to avoid over-outflow of resources from a company (Article 461-2).[2]

The objective of the Corporation Tax Law, on the other hand, is to ensure the fair calculation of the taxable income of companies. This law allows corporations to deduct only those expenses that are included in the income calculation according to the Companies Act (Articles 2-25) and are settled by the general meeting of shareholders (Articles 74-1). The former is called "the principle of recognizing as expense (*Sonkin Keiri Youken*)" and the latter is called "the principle of definite settlement of accounts (*Kakutei Kessan Syugi*)" which originates from "the authoritative principle (*Maßgeblichkeitsprinzip*)" adopted in Germany. These principles have been criticized in Japan because when a company has the option of selecting one of several accounting methods, the corporation inevitably adopts the method prescribed by the Corporation Tax Law to achieve tax saving, even if the method does not reflect the economic substance of the transaction. This company activity is caused by the "principle of reverse authoritativeness (*umgekehrte Maßgeblichkeit*)" which also originated in Germany.[3]

The objective of the Financial Instruments and Exchange Act also includes providing useful information for investors. This law entrusts the ASBJ with the development and/or revision of accounting standards, which includes the significant process of global convergence of financial reporting. However, the objectives of the Companies Act and Corporation Tax Law are to calculate distributable surplus and taxable income in order to reconcile interests among managements, shareholders, creditors, tax authorities, and other stakeholders. In these laws, the prudent and conservative nature of measurement bases is given priority to ensure verifiability and objectivity, which has caused problems in relation to the adoption of IFRS in Japan.

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[2] Under the Commercial Code, retained earnings were the main source for the income available for dividends. However, the Companies Act prescribes the surplus available for distribution and allows distribution not only from retained earnings but also from other capital surplus (Article 446).

[3] In Germany, the Act to Modernize Accounting Law (Bilanzrechtsmodernisierungsgesetz: BilMoG) was established in May 2009 and abolished the principle of reverse authoritativeness to prepare more informative financial reporting (Ernst and Young 2009).

3.3 Business Environment: Long-term Corporative Relationships

The economic environment of Japan, as with Germany, has been based on the CMEs, in which long-term cooperative relationships between various stakeholders are fostered. As already noted, the economic environment of the U.S. has been based on the LMEs, in which competition through challenges in the marketplace is encouraged (Kaplan 1997; Vogel 2001, 2006; Schmidt and Spindler 2006). In the CMEs, as is shown in Table 1, the ownership of a company is concentrated, capital markets are relatively illiquid, and managers in the company are allegedly monitored by a combination of banks, large corporate shareholders, and other inter-corporate relationships. In the LMEs, by contrast, capital markets are liquid, the ownership of a company is relatively unconcentrated, and managers are supposedly monitored by an external market and by boards of directors that are usually dominated by outsiders (Kaplan 1997).

Additionally, various stakeholder groups in the CMEs such as managements, institutional investors, creditors, banks, and employees enter into the corporate governance and make crucial decisions based on mainly internal information, whereas in the LMEs, market mechanisms, stock markets, corporate takeovers, and public information play a large role in corporate governance. Furthermore, long-term relationships between firms and employees through life time employment and seniority payment systems are emphasized in the CMEs, whereas external flexible labor markets, performance-based merit payment, and stock option systems are more important in the LMEs than cooperative relationships (Franks and Mayer 1997; Kaplan 1997; Schmidt and Spindler 2002, 2006; Leuz and Wüstemann 2003; Schmidt and Tyrell 2004; Hackethal et al. 2005).

Importantly, these features of the CMEs are consistent with the prudent and conservative nature of accounting practices in Japan, as they are in Germany, especially through hidden reserves, provisions, and retained earnings (Hamamoto 1995; Leuz and Wüstemann 2003; Siebert 2005; Heidhues and Patel 2011). Japanese and German managements generally valued their freedom to hide profits and losses and to manipulate the income statement to smooth out earnings over time. This prudent and conservative nature of accounting practices in Japan and Germany also emphasized the non-consolidated financial statements to calculate distributable and taxable income (Arai and Shiratori 1991; Hamamoto 1995; Leuz et al. 1998; Leuz and Wüstemann 2003; Vogel 2006; Furuichi 2008; Hellmann et al. 2010).

4. The Process towards Accounting Convergence

4.1 Dysfunction of the Japanese Accounting System in the Early 1990s

The Japanese and German CMEs encouraged widespread interest in the competitive advantages associated with their organization-oriented institutions in the 1980s (Konzelmann 2005). Indeed, long-term cooperative relationships of the Japanese and German CMEs between firms and banks, between different firms, and between firms and the labor force through the main bank system (*Hausbank system*), *keiretsu* (inter-firm networks), and lifetime employment system (collective bargaining) promoted economic development in the 1980s. However, because of the profound economic crises in the early 1990s, Japan and Germany were compelled to reform the constellations of relevant infrastructures that linked to form distinct national systems in the 1980s.

Japan faced the worst economic crisis in history in the 1990s. The Nikkei Stock Index fell sharply from nearly 40,000 in December 1989 to under 15,000 in August 1992. Land prices also fell 40 percent on average between 1989 and 1993, which contributed to the crises of the mortgage

Table 1: A Comparison of Japanese, German and U.S. Governance, Finance, Employment and Disclosure Systems

	Coordinated Market Economies (CMEs)		**Liberal Market Economies (LMEs)**
	Traditional Japanese Model	Traditional German Model	The U.S. Model
Governance System			
Interested party	Stakeholder-oriented	Stakeholder-oriented	Shareholder-oriented
Board of directors	Primarily inside directors	Primarily inside directors	Primarily outside directors
Finance System			
Main financing	Relational (indirect) finance	Relational (indirect) finance	Market (direct) finance
Capital concentration	Less concentrated	Concentrated	Dispersed
Capital ownership	Primarily owned by institutional investors such as group companies and financial institutions	Primarily owned by block holders such as allied companies, financial institutions and founding family	Primarily owned by small scale shareholders and institutional investors such as pension and mutual funds
Capital markets	Somewhat liquid	Relatively illiquid	Very liquid
Takeover markets	Minor	Minor	Major
Banking System	Main Bank system	Hausebank system	Fragmented
Employment System			
Job market	Insider job market	Insider job market	Outsider job market
Lifetime employment	Applied	Applied	Not applied
Dismissal	Protected	Protected	Not protected (flexible)
Payment system	Seniority-based payment	Seniority-based payment	Performance-based merit payment
Stock option	Less common	Less common	Common
Disclosure System			
Measurement	Conservative	Conservative	Fair presentation
Disclosure	Lax disclosure	Lax disclosure	Full disclosure
Principal financial statements	Non-consolidated financial statements	Non-consolidated financial statements	Consolidated financial statements

Sources: Based on Kaplan (1997), Schmidt and Spindler (2002, 2006), Schmidt and Tyrell (2004), Leuz and Wüstemann (2003), Hackethal et al. (2005).

lending institutions (called *jûsen*) and the banking industries (Beason and James 1999; Hoshi and Kashyap 2001). To make matters worse, the Japanese government did not disclose information about the jûsen and banking crises. This secretive policy of the Japanese government added to the economic crisis. It was only after 1995 that the Ministry of Finance (MOF) "seems to have realized that the truth is probably better than unfounded speculation, and the magnitude of the crisis has been more or less openly revealed" (Beason and James 1999, p.84).

These economic crises intensified criticism of the Japanese reporting system. Indeed, during the long-term economic depression of the 1990s, the practice of strict historical cost accounting contributed to the ability to hide substantial unrecognized losses from bad loans, tangible assets, and pension liabilities. Because of strict historical cost accounting, the Japanese reporting system also failed to disclose the risk concerning financial instruments including derivatives. Moreover, because of the dependence on non-consolidated financial statements, accounting fraud using a complexity of subsidiaries and affiliate companies occurred (Hiramatsu 1998; Vogel 2001; Benston et al. 2006; Furuichi 2008).

In essence, the principle of unity, the triangular legal system, and the prudent and conservative nature of the Japanese accounting system were seen as obstacles to convergence with internationally accepted accounting standards. A code-oriented system implemented through a strong central government was slow to respond to the fast-changing environment (Gernon and Meek 2001).

4.2 Significant Accounting Reforms: The Accounting Big Bang

Due to the profound economic crises in the 1990s, significant reforms were initiated in Japan with the introduction of the "Financial Big Bang" in 1996 and the "Accounting Big Bang" in 1997. The term "Big Bang" has been used in Japan to reflect the significant financial, accounting, and political changes that took place in the late 1990s and early 2000s.

To address the economic crisis and the repetition of manipulation that resulted from strict historical cost accounting and dependence on non-consolidated financial statements, the Big Bang was implemented by the adoption of three principles; namely, the establishment of *free, fair* and *global* capital markets. Because the objective of the Big Bang included introducing competition through market mechanisms into accounting, financial, governance, and employment systems, enhancing the Japanese disclosure system including financial statements, and accelerating the internationalization of Japanese accounting system, these reforms inevitably pushed Japan to move toward IFRS, the Anglo-American model, and LMEs.

In fact, principal financial reporting was changed to consolidated financial statements in 1997, which involved the application of consolidated statements of cash flows, interim consolidated financial statements, and tax effect accounting. By adopting the "control criterion", which reflects the power to govern the financial and operation policies of an entity, the scope of consolidation enlarged considerably compared to the over 50 percent criterion. These changes accelerated group-wide management and restructured non-performing subsidiaries and associates (METI 2004; Furuichi 2008).

Moreover, fair value measurement was introduced for trading securities, derivatives, and available-for-sales securities in 1999. The introduction of fair value measurement overcame the defectiveness of strict historical cost accounting because fair value constrains profit equalization management and discloses the result of risk management. Similarly, fair value and present value were introduced into the accounting standard for retirement benefits in 1998. According to this standard, provisions are calculated by the difference between the amount of retirement benefits obligations valued at present value and the amount of pension assets valued at fair value. This change accelerated the adjustment of an ossified lifetime employment system.[4]

These significant reforms of accounting standards highlight substance-over-form by adopting the concept of control for consolidated financial statements and by introducing future-oriented measurement attributes such as fair value and present value for financial instruments and pension assets and liabilities. Consistent with these accounting reforms, auditing standards were fully revised to enhance auditing for detecting frauds, to apply risk approach for clients' internal control systems, to incorporate auditing for going concerns (auditors' information about bankruptcy risk), and to require substantial exercise of professional judgment (BAC 2002). Moreover, in accordance with the U.S. Sarbanes-Oxley Act of 2002, which was enacted to respond to the Enron scandal, the Japanese Certified Public Accountants (CPA) Law was fully revised for the first time in 60 years. To enhance auditor independence and oversight, the CPA Law incorporated: (1) prohibition of the provision of certain non-audit services simultaneously with audit services (Article 24-2), (2) requirement of audit partner rotation (Articles 24-3; 34-11-3), and (3) establishment of the Certified Public Accountants and Auditing Oversight Board (CPAAOB) (Articles 35-42).

As with the IASB and the U.S. Financial Accounting Standards Board (FASB), the ASBJ was established as a private-sector accounting standards-setting body in July 2001. The objective of the ASBJ is to promote corporate disclosure and soundness of capital markets by developing generally accepted accounting standards through transparent and fair procedures. The fact that the ASBJ was established as a private standards-setting body is of significance, because this change implies that the ASBJ is expected to develop accounting standards to meet the fast-changing economic environment beyond the restrictions of the Financial Instruments and Exchange Act, the Companies Act and the Corporation Tax Law (Egashira 2005; Saito 2007).

Through these significant reforms of the accounting, auditing, and standards-setting body, which highlighted competition through marketplaces, transparency of disclosure system, and the internationalization of the Japanese accounting and auditing standards, the Japanese accounting system has moved toward IFRS and the Anglo-American model. As a result of these achievements, the Financial Service Agency (FSA), the ASBJ, and the Japan Institute of Certified Public Accountants (JICPA) announced in a joint statement that "Accounting, auditing and disclosure systems in Japan are essentially equivalent to and consistent with internationally recognized systems" (FSA et al. 2004).

Additionally, to examine the quality of financial reporting system in Japan, the Committee of European Securities Regulators (CESR) conducted the assessment of the equivalence of Japanese Generally Accepted Accounting Principles (GAAP) with IFRS (CESR, 2005). The CESR's conclusion was that Japanese GAAP, taken as a whole, is mostly equivalent to IFRS, subject to limitations of 26 differences which needs to be addressed. The ASBJ eliminated the major differences between Japanese GAAP and IFRS by the end of 2008. The accomplishment of the Big Bang and recent reforms towards IFRS and the Anglo-American model resulted in a reasonably high quality financial reporting system. Eventually, the European Commission (EC) accepted that the Japanese GAAP is equivalent to IFRS that are adopted by the EU (EC 2008a, b).

[4] In addition to these accounting standards, the following standards were newly established and/or revised during 1998-2004. Research and development costs (1998), Foreign currency transactions (1999), Impairment of fixed assets (2002), Treasury shares and reversal of legal reserves (2002), Earnings per share (2002), Business Combination (2003). These standards followed either IFRS or U.S. GAAP.

5. Further Reforms towards the Anglo-American Model

5.1 The Cautious Convergence Approach by Design

During the Big Bang, long-periods of adjustment were prepared until new accounting standards were applied mandatorily. For example, though accounting for impairment and business combinations standards were issued, it was three and a half years before these newly-established accounting standards were applied mandatorily.[5] These deferments were caused by firms' resistance to adopting new accounting standards. In fact, most newly-established accounting standards constrained freedom to hide profits and losses, made it difficult to manipulate accounting figures, and restricted traditional Japanese business customs such as cross-shareholdings, *keiretsu*, defined benefits pension plan, and lifetime employment system (Vogel 2001, 2006; Furuichi 2008). However, it is also important to note that the Japanese government adopted a cautious convergence approach by design to align new accounting standards with auditing standards, the Commercial Code, and the Corporation Tax Law.

The evidence shows that, consistent with the Accounting Big Bang, surrounding infrastructures such as the Commercial Code and the Corporation Tax Law were reformed significantly. The objectives of the Commercial Code and the Corporation Tax Law were to calculate distributable and taxable income based on verifiable and objective measurement models. In these laws, the application of the consolidated financial statements and fair value measurements had not been recommended (Arai and Shiratori 1991). However, consistent with the revision of accounting standards, these laws adopted fair value measurement for certain financial instruments and retirement benefits. The Commercial Code allowed large companies to disclose consolidation financial statements and the Corporation Tax Law allowed companies to adopt a consolidated taxation system under a specific condition.

Moreover, as Japanese accounting standards moved towards the investor-oriented Anglo-American model, the Commercial Code reinforced provisions for pursuing the efficiency of capital and accelerating business restructuring. The objective of this change was to promote competition in the marketplace. These new provisions included the introduction and relaxation of share buy-backs, treasury stocks, share exchanges, reduction of regal reserves, and distributable amount of surplus. Even the Corporation Tax Law, which is irrelevant to investors' perspective in nature, followed some parts of these revisions such as provisions on treasury stocks and share exchanges. This reconciliation process among accounting standards, the Commercial Code, and the Corporation Tax Law is shown in Table 2.

These changes indicated that accounting standards, the Commercial Code, and Corporation Tax Law were moving towards the Anglo-American model and the LMEs simultaneously and complementarily. Surrounding infrastructures such as governance and employment systems were also reformed towards the Anglo-American model and the LMEs by seeking efficiency through market mechanisms. Indeed, the outside auditor system was introduced in 2001 under the Commercial Code, whereby it is a requirement that more than half members of auditors in large companies must be outside auditors (Article 335). An optional committee system was introduced in 2002 and the U.S governance style featuring an outside director system is allowed (Article 400). Similarly, many companies introduced elements of the U.S. employment style, such as merit payment and defined

[5] The accounting standard for the impairment of fixed assets was issued in August 2002 but adopted mandatorily from the beginning of the fiscal year April 2005. Similarly, the accounting standard for business combinations was issued in October 2003 but adopted mandatorily from the beginning of the fiscal year April 2006.

Table 2: Reconciliation Among Accounting Standards, The Commercial Code, and The Corporation Tax Law

Significant Changes	Accounting Standards	The Commercial Code	The Corporation Tax Law
Consolidated financial statements	Accounting standard for consolidated financial statements revised (1997)	Disclosure of consolidated financial statements for large companies required (2002)	Consolidated taxation system introduced (2001)
Fair value measurements	Accounting standard for retirement benefits issued (1998)		Allowance for employees' retirement benefits de-escalated (1998)
	Accounting standard for financial instruments issued (1999)	Fair value measurement for certain securities allowed (1999)	Fair value measurement for certain financial instruments applied (2000)
Deregulation regarding the reduction of capital and regal reserves	Accounting standard for treasury shares and reversal of legal reserves issued (2002)	Stock options and share buy-backs deregulated (1997)	Taxation of sale of treasury stocks revised (2001)
		Share buy-backs and cancellation of shares further deregulated (1998)	
		Legal reserves, capital reduction, and treasury stocks deregulated (2001)	
		Distributable amount of surplus deregulated (2001)	
Business reorganization	Accounting standard for business combinations issued (2003)	Establishment of bank holding companies allowed (1999)	Exception to taxation of share exchanges issued (1999)
		Share exchange system introduced (1999)	Taxation of corporate reorganization revised (2001)
		Corporate spin-offs system introduced (2000)	

Note: The cautious and continuous reconciliation processes can be recognized from this table. For example, a new accounting standard introduced fair value measurements for certain financial instruments in 1999. Consistent with this change to the new accounting standard, the Commercial Code and the Corporation Tax Law also introduced fair value measurements for such items in 1999 and in 2000 respectively.

contribution plan (Nippon Keidanren 2000; METI 2004; Furuichi 2008). However, these U.S. style systems were mostly introduced as "choice" which enabled new practices, rather than being imposed as mandatory requirements.

In addition to these reforms, the *optional* adoption of IFRS commenced in Japan at the end of the fiscal year March 2010 for the consolidated financial statements of listed companies. Importantly, it will be obligatory to change from the cautious convergence approach to the direct adoption approach if the government decides to enact the mandatory adoption of IFRS. According to the original plan in 2009, the decision concerning the adoption of IFRS will be made around 2012 and is likely to come into effect after 2015 (BAC 2009). However, in June 21, 2011, Shozaburo Jimi, the Minister of Financial Services, delivered a statement about the postponement of the decision concerning the adoption of IFRS. The Minister suggested that the *mandatory* adoption of IFRS should not take place before 2015, and a sufficient time period of five to seven years should be required for preparation if the *mandatory* adoption of IFRS is confirmed in Japan.[6]

It is also important to note that although the Cabinet Office Regulation No.73 issued in December 2009 described a prohibition on the use of U.S. GAAP with effect from the fiscal year March 2016, the Minister announced the finalization of the removal of this time limit in June 2011 (Jimi, 2011). Consistent with this announcement, the Cabinet Office Regulation No.44 issued in August 2011 removed this time limit so that Japanese firms can continue their use of U.S. GAAP. This policy change clearly indicated that the Minster supported the "cautious convergence approach" rather than the "direct adoption approach."

5.2 More Focus on Intrusive Events than Domestic Reconciliation

Reforms of disclosure, financial, governance, employment systems progressed simultaneously and complementarily during the Japanese Big Bang period, as already noted. After 2005, however, when IFRS were adopted mandatorily in the EU, intrusive events such as the strategies of the EU and the SEC became more important than domestic reconciliation. In the EU, the adoption of IFRS was made mandatory for European listed companies from January 2005 (EC 2002, 2003, 2004).

Similarly, in the U.S. the move towards convergence commenced by the so-called "Norwalk Agreement" between the IASB and the U.S. FASB in 2002. In response to this agreement, the U.S. SEC Chief Accountant Donald T. Nicolaisen prepared a roadmap in April 2005. This roadmap, which was officially approved by the SEC Chairman Christopher Cox, eliminated the reconciliation requirements for non-U.S. registrants that adopted IFRS from November 2007 (SEC 2005, 2007a, 2007b). Moreover, the U.S. SEC published a roadmap in November 2008, which includes two proposals, namely the optional adoption of IFRS for certain U.S. issuers from January 2010 and several milestones for the potential use of financial statements prepared in accordance with IFRS (SEC 2008).[7]

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[6] The Minister's decision was influenced by several factors: (1) the announcement to postpone the adoption of IFRS in the U.S. by the SEC; (2) the strong request to postpone the adoption of IFRS in Japan by the representatives of twenty-one leading Japanese companies together with the Japan Chamber of Commerce and Industry; (3) the resistance of the Japanese Trade Union Confederation; (4) the unprecedented earthquake and tsunami in March 11, 2011; and (5) contextual factors characterizing Japan's institutional environment such as the economy and legal system (Jimi 2011).

[7] The U.S. SEC issued a commission statement in February 2010, which rescinded a regulation concerning the optional adoption of IFRS for certain U.S. issuers (SEC 2010).

Consistent with these decisions made by the EU and the U.S. SEC, the ASBJ made significant agreements with the IASB in 2007, which was the so-called "Tokyo agreement," to accelerate convergence. As a result of these agreements, *optional* adoption of IFRS commenced in Japan at the end of the fiscal year March 2010 for the consolidated financial statements of listed companies. These global trends promoted the establishment of the Companies Act in July 2005 and the Financial Instruments and Exchange Act in June 2006. These laws were revised significantly to incorporate important parts of the U.S. Corporation Act and the Sarbanes-Oxley Act of 2002.

Prior to its revision in 2002, the Commercial Code regulated measurement practices, which supported the prudent and conservative nature of accounting practices for creditor protection. However, the Companies Act abandoned the setting of measurement rules in 2005 and has come to rely on other measurement rules described by the Financial Instruments and Exchange Act.[8] The concrete rules regarding the distributable amount of surplus are enacted by the Ministry of Justice ordinance (Article 461-2). These functional decompositions were accelerated so that Japanese standards-setting bodies could revise accounting standards quickly according to the revision of IFRS beyond the restrictions of the Financial Instruments and Exchange Act, the Companies Act and the Corporation Tax Law (Egashira 2005; Saito 2007). In other words, Japanese standards-setting bodies have come to prepare accounting standards without being influenced by the principle of unity, the triangular legal system, and the principle of recognizing as expense.

As Japanese accounting standards moved towards the Anglo-American model, the Companies Act highlighted the "efficiency of capital" rather than the "maintenance of capital" by the further relaxation of regulations regarding the reduction of capital and regal reserves (Articles 447-448). Such deregulation is contrary to the conventional principle in the Commercial Code that creditor protection is achieved by avoiding over-outflow of resources from a company through dividend regulation. As such, the Companies Act changed its policy of reconciliation of interests from "the capital maintenance model with strict dividend regulation" into "the full disclosure model with flexible dividend regulation." These changes imply the move from the German Commercial Code towards the U.S. Corporation Act (Hamada 2005). Similarly, the Financial Instruments and Exchange Act introduced Internal Control Reporting over the Financial Reporting System (*Naibu Tôsei Hôkoku Seido*) in 2006, which is patterned after the corporate governance system in the Sarbanes-Oxley Act of 2002 (Article 24-4-4). This change is expected to improve the reliability of the Japanese disclosure system by enhancing the internal control system in Japan.

6. The Complex Equilibrium Paths toward Convergence

6.1 Unique Reforms of the Japanese Accounting System

Initially, the Japanese regulatory authorities such as the BAC and the FSA suggested that both consolidated and non-consolidated financial statements should be prepared by IFRS,

[8] The Companies Act states that: "The financial reporting of a joint-stock corporation (*Kabushiki Kaisha*) is subject to generally accepted accounting practices for business enterprises" (Article 431). Generally accepted Japanese accounting practices include the measurement rules described by the Financial Instruments and Exchange Act and accounting standards prepared by the BAC and the ASBJ.

if the mandatory adoption of IFRS is enacted in Japan (BAC 2009).[9] Hidenori Mitsui, the head of the business disclosure section of the FSA, explains the reason to recommend this approach as follows. "Consolidated financial statements are based on non-consolidated financial statements within an enterprise group thereby financial statements of both parent company and its subsidiaries must be prepared in accordance with the same generally accepted accounting standard" (Mitsui 2009, p.35).

Japanese business federations, however, including the Nippon Keidanren, have consistently opposed the adoption of IFRS for non-consolidated financial statements. Instead, the Nippon Keidanren has suggested for the more prompt response to IFRS adoption for certain global enterprises that prepare consolidated financial statements in order to revitalize capital markets, whilst the simplification of non-consolidated financial statements to reduce the preparation costs for the other entities (Nippon Keidanren 2008, 2009, 2010).[10] Under this separation of consolidation and non-consolidation approach (hereinafter, "separation approach"), the connection between these financial statements will be made separate. The dependence between the Financial Instruments and Exchange Act, which regulates mainly consolidated financial statements, and the Companies Act, which regulates mainly non-consolidated financial statements, will also inevitably be made separate. As such, this approach makes the maintenance of the principle of unity and the triangular legal system less important.

This separation approach induces further argument concerning the separation of the connection between financial reporting and tax law. Indeed, Japan has adopted the single-reporting regime in which accounting standards and tax law are highly dependent. The principles of recognizing as expense and the definite settlement of accounts have permeated accounting practices. However, opinions that reexamination of these principles is needed are widely encountered, especially for listed companies, in order to make the consolidated financial statements converge with IFRS promptly (Nippon Keidanren 2008, 2009, 2010). At the same time, opinions that these principles should be maintained are rigid, especially regarding the financial statements for SMEs, considering the burden of preparation costs and lack of human resources. Because the accounting systems of SMEs are oriented towards calculation of taxable income, the simplification of accounting standards and elimination of fluctuant accounting figures caused by the extensive application of fair value measurement are strongly recommended (JICPA 2010).

As intrusive events increase in influence, domestic reconciliation becomes more difficult. Indeed, the differentiation of the functions between consolidated and non-consolidated financial statements, between the Financial Instruments and Exchange Act and the Companies Act, between financial reporting and the calculation of taxable income, and between the accounting standards for large companies and SMEs is progressing through complex paths. Contrary to the claim that convergence directs the "best design" practices closely akin to the Anglo-American model (McDonnell 2002; Hansmann and Kraakman 2004; Pinto 2005), the move towards the Anglo-American model and the LMEs do not represent a complete break with past Japanese patterns of disclosure, financial, governance, and employment systems.

[9] More specifically, they suggested that consolidated financial statements should be converged on IFRS swiftly, while non-consolidated financial statements should be converged after finishing domestic reconciliation with other systems including distinctive trade practices, traditional accounting practices, the Companies Act, and the Corporation Tax Law (BAC 2009).

[10] The Nippon Keidanren (Japan Business Federation) is a broad-based economic organization whose members include over 1,600 major Japanese corporations, 129 industry organizations, and 47 regional economic organizations in 2010.

6.2 Unique Reforms of Other Infrastructures

The banks' shareholding ratio and cross-share holding ratio have declined from 42.8% in 1991 to 29.7% in 2010 and from 27.7% in 1991 to 6.5% in 2009 respectively, whereas the foreign investors' ratio increased from 6.0% in 1991 to 26.7% in 2010 (Ito 2010; Tokyo Stock Exchange 2011). Consistent with these changes, a long-term corporative relationship between a bank and a company through lending, cross-shareholdings, and interlocking directors is dissolving significantly. However, in the face of the recent financial crisis stemming from the subprime loan problem in 2008, most companies have increased bank borrowings as a stable financing method. In other words, most companies maintain a close network with their main banks. This is because Japanese companies still expect that the main banks will furnish funds in a financial crisis and will bail out in financial distress, thereby reducing financing risks and hedging bankruptcy risks (Hirota 2009; Japan Cabinet Office 2010). Cross-shareholdings are still utilized for forming capital alliances to expand business and to defend against hostile takeovers (Ito 2008).

The evidence that not all systems are moving towards LMEs can also be seen in the reforms to corporate governance. In the CME countries, the board of directors is dominated by insiders such as executives of the company, interlocking directors, managers of closely associated companies, and bank representatives. However, an optional committee system was introduced in Japan in 2002 as a result of revisions to the Commercial Code. In a company with a committee system, the functions of the board of directors and corporate executives are separated and more than half members of directors must be chosen from outside directors.[11] This revised Commercial Code facilitated the adoption of U.S. governance style, but was designed as an "option" that enabled rather than mandated change. This reform as "choice" represents an important political compromise to enable new practices, rather than imposing strict mandatory requirements. Importantly, "choice" was the product of compromise, not overwhelming consensus on the advisability of moving towards U.S. style corporate governance (Gilson and Milhaupt 2004).

Similarly, the employment system has changed towards the LMEs. As shown in Table 3, 58.2% of Japanese companies introduced merit payment. However, 29.8% of Japanese companies are still classified as CMEs (traditional Japanese model), 18.3% are LMEs (the U.S. model), 39.9% are the Hybrid Model (new Japanese model), and 12.0% are the Inverse Hybrid Model (inversely mixed model) (JILPT 2005). The survey also shows that 69.7% of Japanese companies maintain a long-term employment system (JILPT 2005). It is well-known that Japanese companies have managed human resources flexibly to preserve a long-term employment system by transferring redundant employees to group companies, by introducing an early retirement plan with a premium allowance, by cutting wages without violating commitment to stable employment, and by restricting the long-term employment system to core employees (Vogel 2001, 2006; MHLW 2008). As such, the U.S. employment style was introduced in ways that were consistent with the existing employment system. Importantly, Japanese companies still expect that employee-oriented policy will make employees' long-term commitment possible. These long-term corporative relationships have boosted efficiency, innovation, and competitiveness in Japanese manufacturing firms (Aoki 1994; Dore 2000; Itami 2000; Jacoby 2000; Vogel and Zysman 2002; Konzelmann 2005; Vogel 2006; Clarke 2007; Jackson and Miyajima 2007; Tatsumichi and Morishima 2007; JILPT 2010).

[11] In addition, at least three committees, namely the nominating, audit, and compensation committees, must be established within the board of directors (Companies Act, Article 2-12).

Table 3: Influence of Merit Payment on The Long-Term Employment System: The Percentage of Companies

	Long-term employment maintained	Long-term employment abandoned	Total
Merit payment not introduced	**CMEs** (29.80%)	Inverse Hybrid Model (12.00%)	41.80%
Merit payment introduced	Hybrid Model (39.90%)	**LMEs** (18.30%)	58.20%
Total	69.70%	30.30%	

Data Source: JILPT (2005)
Note: The survey was conducted from October 15, 2004 to December 24, 2004 for 11,865 private companies with more than 200 employees. Valid responses were 1,214 companies (10.8%).

In aggregate, as shown in Table 4, the equilibrium paths towards the LMEs are controversial and complex, and include the CMEs (traditional Japanese model), the LMEs (the U.S. model), the Hybrid Model (new Japanese model), and the Inverse Hybrid Model (inversely mixed model). Japanese firms can choose from a wide menu of market-based options such as direct financing, bond issue, the committee system, stock option, merit payment, and other performance-based incentive systems to optimize a set of different sub-systems that complement one another. Importantly, transplanting the Anglo-American model and LMEs without considering the institutional complements of each country may lead to serious problems later, and these problems may impede, or reverse convergence (Gordon and Roe 2004).

7. Concluding Remarks

Using the accounting ecology framework of Gernon and Wallace (1995), this paper investigates the interrelationships of the related accounting, historical, legal, business and economic environment in Japan and provides deeper insights into the Japanese accounting system and surrounding infrastructures, such as the financial, governance, and employment systems. We provide evidence that the Japanese government has not adopted IFRS unquestioningly but has arranged it so that new rules reflect specific Japanese demands and contextual factors such as the historical, legal, business, political, and economical environments.

As a result of the profound economic crises in the 1990s, significant reforms were initiated by the "Accounting Big Bang" in 1997. The ASBJ was established in July 2001 to develop accounting standards without being influenced by the principle of unity, the triangular legal system, and the principle of recognizing as expense. During the Accounting Big Bang, however, the domestic reconciliation of accounting standards and surrounding infrastructures such as the Securities and Exchange Law, the Commercial Code, and the Corporation Tax Law was promoted by design.

Table 4: Diversification of The Japanese Financial, Governance, and Employment Systems

Financial System	**Governance System/ Employment System**	
	Insider Control/ Insider job market	Outsider Control/ Outsider job market
Relational finance	**CMEs**	Inverse Hybrid Model
Market finance	Hybrid Model	**LMEs**

Note: Financial System: relational-oriented (e.g. bank finance, cross-shareholdings) or market-oriented (e.g. stock issues, bond finance). Governance System: insider control (e.g. stakeholder-oriented, insider boards) or outsiders control (e.g. shareholder-oriented, outsider boards). Employment System: insider job market (e.g. lifetime employment, seniority pay) or outsider job market (e.g. merit payment, stock options).

As such, the cautious convergence approach during this period justified the move towards the Anglo-American model and the LMEs. In contrast, after 2005 in particular and following the mandatory adoption of IFRS in the EU, intrusive events such as the strategies of the EU and U.S. SEC became more important than domestic reconciliation. During this period, intrusive events discouraged Japanese regulators and companies from further domestic reconciliation and accelerated the diversification of domestic business and accounting practices. In other words, convergence has promoted domestic functional differentiation between consolidated and non-consolidated financial statements, between the Financial Instruments and Exchange Act and the Companies Act, and between financial reporting and the calculation of taxable income. Accordingly, this paper rejects the simplistic assumption that countries move directly towards the Anglo-American model and the LMEs because of global convergence.

Core reforms of the surrounding infrastructures in Japan were achieved not as a compulsion, but as a “choice” from a wide menu. These reforms as “choice” do not show consensus on the movement towards the Anglo-American model and the LMEs but the inclination and ingenuity to create a new Japanese model. Therefore, the Japanese equilibrium paths from the Continental-European model/ the CMEs towards the Anglo-American model/the LMEs have been controversial and complex. The paths include unique convergence routes such as through the “Hybrid Model” and the “Inverse Hybrid Model”. Some Japanese companies have adopted the Hybrid Model, which relies on market-oriented financing but retains some traditional Japanese features such as insider-oriented corporate governance and stable employment system. Others have adopted the Inverse Hybrid Model, which is still dependent on bank financing but introduces outsider-oriented corporate governance and a performance-based employment system. Recent research also shows that the Hybrid Model that combines contradictory elements such as a market-based financial system, main bank system, insider-oriented governance system, and life time employment system is superior to the pure forms of the Anglo-American model and LMEs (e.g. Jackson and Miyajima 2007; Tatsumichi and Morishima 2007; Hirota 2009; Japan Cabinet Office 2010; JILPT 2010).

Our findings are consistent with the institutional complementarity perspective that provides insights into the divergence of economic, financial, and governance systems based on the complementarities of surrounding infrastructures. This perspective assumes a plurality of models and emphasizes the systemic links between different institutions so that they fit together well and mutually increase their benefits (see Aoki 1994; Gordon and Roe 2004; Schmidt and Spindler 2006).

We conclude by pointing out that it seems unlikely that IFRS would supersede Japanese GAAP completely, or that the Anglo-American model and the LMEs would replace the Continental-European model and the CMEs absolutely. Optimal mechanisms of the accounting system and its surrounding infrastructures are contextual and embedded in the accounting ecology of each country. The findings of this study have implications for achieving *de facto* convergence because optimal mechanisms of the accounting system and its surrounding infrastructures, such as disclosure, financial, governance, and employment systems, are contextual and are embedded in the accounting ecology of each country.

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