# Significance of Convergence and the Role of IFRS in Japan:

## To encourage IFRS to be accepted by converging countries

Shizuki Saito*

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* Professor, Department of Economics, Meiji Gakuin University ; Previous Chairman, Accounting Standards Board of Japan .

## 1. Introduction: Convergence as a Crucial Concept

Although International Financial Reporting Standards (IFRS) have recently received wider attention in Japan than before, still relatively few Japanese companies are familiar with them. It is true that IFRS are of great concern to the Japanese companies that are raising equity funds in Europe, but, according to data from the Japanese Financial Services Agency, the number of such companies decreased from eighty-three as of January, 2002 to twenty-six as of September, 2006,[1] which account for approximately one percent of the entire listed companies in Japan. We can view this rapid decline as a result of the announcement that no financial statements other than those based on IFRS (or other standards that are equivalent to IFRS) be admitted in Europe, while companies that are faced with the urgent need to take IFRS into consideration are rather few in Japan.

The downward tendency also suggests that many companies would not consider it worthwhile to be listed in European markets should they incur such extra cost in disclosing their financial statements. In fact, the majority of the Japanese companies raise most of their funds in domestic markets.[2] Moreover, both Japanese and non-Japanese investors who participate in Japanese markets perceive that Japanese accounting standards are on a par with international accounting standards.[3] On the other hand, companies listed in the U.S. must report their financial statements on US GAAP, but they are allowed to use these US-based statements in Japan. Given these facts, despite the growing concern with the equivalence assessment by the European Commission (EC), IFRS have not received due recognition among Japanese companies and investors in general.

As is often asserted, capital markets would require a higher risk premium or foreign investors might withdraw from Japanese markets if the standards used there were regarded as local. We ourselves often make such a warning remark. However, despite this argument, there has been a rapid growth in the proportion of foreign investors in transactions on the first section of Tokyo Stock Exchange (TSE), and it is reported that they account for more than 50% in terms of sales transactions in fiscal year 2006 (from April 2006 to March 2007).[4] Investors simply pursue profits in return of the risk they bear, and they will not retreat from the markets as long as they believe they have the enough information to invest and expect reasonable return.

However, the above argument does not imply that the significance of convergence has lessened for the Japanese markets. As discussed later in section three of this paper, Japan has become part of the global capital market and is now ranked the second only to the U.S. as a national market. Therefore, accounting standards used in TSE should not be isolated from the global accounting standards. If IFRS remain to be of concern exclusively for the companies

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1 FSA, “Japanese Issuers in EU Markets”, Unpublished, November, 2006.

2 Many Japanese companies issue bonds in Europe, but they are not required to report their statements based on IFRS if they only issue straight corporate bond.

3 We argue the level of the accounting standards in Japan later in section two of this paper, but if our goal were to merely catch up with EU, our claim is that we have already achieved the goal. For example, we have adopted fair-value accounting for financial instruments and accounting rules for retirement benefits before EU and just after the U.S. Also, in terms of setting the criteria for substantial control to extend the scope of consolidation, we are far ahead of the rest of the world. As for the standards regarding impairment of the fixed assets, we have reflected the merits of both US GAAP and IFRS. In terms of business combinations, we have set comprehensive standards that even cover the transactions under common control.

4 Nihon Keizai Shinbun (Nikkei), March 31, 2007.

that are listed in Europe, no party has any incentive to harmonize Japanese accounting standards with global accounting standards; in other words, at one end there are companies reporting on international standards, and at the other end, there are companies reporting on Japanese standards, with these two groups kept apart permanently. In fact, this is the last thing we want.

It is important for Japanese accounting standards to be constantly competing with the international standards, so the former will be given no choice but to harmonize with the latter. If investors are allowed to assess the quality of the accounting standards companies use for their financial reports, both Japanese and international standards should be given opportunities to be improved. This implies that when setting domestic standards, we must have it in mind that they will be compatible with international standards. In other words, we must have the vast majority (ninety-nine percent) of the companies keep step with the tiny (one percent) force without those in the former group being dropped out. It goes without saying that the reference point would be IFRS. That is why the Accounting Standards Board of Japan (ASBJ) has focused its efforts on developing accounting standards through the joint project with the International Accounting Standards Board (IASB).

In the rest of the paper, we discuss some perspectives on and problems of IFRS, and discuss what kind of target should be set in the course of establishing global accounting standards. To do so, we explain a series of reforms on Japanese accounting standards which started at the end of the last century (so called the accounting big bang), the ASBJ’s serious efforts to set domestic accounting standards keeping international convergence in mind, and some basic ideas behind them (our basic policy and conceptual framework). In terms of conceptual foundations, we refer to some academic arguments concerning the concepts and measurement of capital and income in order to strive for universally valid perspectives beyond national boundaries.

## 2. Accounting Standards Reforms in Japan

The development of capital markets and the reforms in accounting standards have been led by regulating authorities in Japan. The government has modeled them on the U.S. system based on Securities and Exchange Law, which was introduced into Japan after WWII. The accounting big bang starting from the late 1990s can be considered the final phase of postwar reforms; a series of reforms on consolidation policies, retirement allowances, financial instruments, impairment of fixed assets, and business combination is said to have made Japanese accounting standards comparable to those of the West. To put it another way, Japan has caught up with the West in terms of accounting standards. Therefore, the accounting systems of Japan, the U.S., and European Union (EU) are all at the frontiers and they now have to respond to their own issues rather than just following the standards of others.

ASBJ as well as IASB were established in 2001, when Japan began to push forward the accounting reforms in the above stated manner. From this year onwards, the accounting standards are to be developed by an organization supported by those who actually participate in financial markets, so that standards meet both the needs of the markets and demand for convergence as part of globalization. This is an epoch-making social experiment in the sense that a private sector takes a substantial role in developing public regulations in a country where accounting standards have long lacked flexibility under the straitjacket of legal systems for they were bound not only by Securities and Exchange Law but also by Commercial Codes (Corporate Law) and Corporate Tax Law.

In order to play such a role, the ASBJ should develop accounting standards that would make a contribution toward the establishment of the more integrated international capital market. Needless to say, this must be done in line with other reforms in the domestic systems. The ASBJ has so far made good progress. For example, in such fields as presentation of net assets, stock options, quarterly disclosures, and finance leases, new standards have been developed. Specifically, the first two have been amended in relation to a series of Commercial Codes reforms, the third with Securities and Exchange Law reform, and the last with the Tax Law reform. Furthermore, the ASBJ has already completed reforms in standards covering measurement of inventories, related party disclosures, and unification of accounting policies applied to foreign subsidiaries, and is now focusing its efforts on revising those regarding disclosure of financial instruments, scope of consolidation, contract revenue, and asset retirement obligations to mention only a few. Business combination is also under deliberation based on the market responses to our current standard taken effect in 2006.

Although the ASBJ has been successful in its mission so far, it is undeniable that we suffered the lack of understanding by other nations when the size and the infrastructure of Japanese capital markets were not known to the rest of the world. Our objective was (and is) to seek international convergence working together with the U.S. and EU, and simultaneously developing our national standards independently. In the first place, however, the idea was not understood abroad and Japan was once labeled as a country that did not make a commitment to convergence, together with Iceland and Saudi Arabia (the U.S. was not so considered though).[5] Conceivably when the IASB was first created, it would strive to make every other nation except the U.S. accept IFRS unconditionally, and then these nations in unison would enter into negotiation with the U.S. However, as is later described in this paper, Japan did not fit in with this scenario well.

The turning point was the summer of 2004, when Sir David Tweedie, Chairman of the IASB, proposed a joint project to encourage the convergence of Japanese GAAP and IFRS. The proposal was to reduce the differences between the two standards as of 2004 “based on our respective conceptual frameworks”. To launch this joint project successfully, we first classified easier issues into the first phase, and deferred more time-consuming ones to the later phases. As for the conceptual framework, we agreed on taking this issue up when the boards of both committees agree to do so.

The first session of our joint project was held in March 2005 in Tokyo. Since then, we have been holding conferences every half-year in London and Tokyo alternately. The ASBJ not only accomplished almost all the issues that were classified into the first phase within a year, but has been discussing the conceptual framework from the very beginning, although this issue was not formally included in the first phase. In March 2006, when we judged that the project had been going on wheels, we suggested that we revise our first plan. That is, we stopped classifying issues based on their tractability but adopted a new comprehensive strategy. In this new approach, we first listed up all the differences between IFRS and Japanese GAAP. Then, we classified them into short-term and longer-term projects. This has allowed us to undertake both types of projects simultaneously, based on their priorities. It was

[5] International Forum on Accountancy Development (IFAD) Report, “GAAP Convergence 2002”.

intended to strengthen the ongoing convergence project by examining the difference generated one after another in markets.

The IASB, the “seller” of the international standards may argue that the process is taking too much time. But, the social practices and institutions including accounting standards are path dependent in nature, i.e., they are bound by their own histories. Therefore, it is natural to share the same goal internationally, but the process to reach that goal may vary from society to society. Insofar as the present system is actually functioning, the process of the reform is as important as the result itself. We have been sending messages on our reform process from the above mentioned point of view to the rest of the world, and we will keep doing so. Moreover, we consider this is why the joint project with the IASB has significance.

In the meanwhile, there have been tremendous efforts to make convergence in the U.S. and EU. The FASB and the IASB have agreed to jointly develop accounting standards even for long-term projects. Also concerning the conceptual framework, both boards have been making progress on the revisions. The ASBJ is expected to make a contribution toward global convergence by committing itself to this joint project. Therefore, we have always been ready to provide off-site opinions regarding long-term projects including some conceptual ones. This is perhaps one of the reasons why we are not expected to spend too much time on short-term projects.

However, we cannot but stress the importance of the short-term projects in Japan because Japan must meet “equivalence assessment” posed by the EC. The EC has required all non-European companies within the EU to prepare their consolidated financial statements in compliance with IFRS if they wish to raise funds through equity markets, starting from 2009. For countries that have no plans of adopting IFRS as their sole standards, CESR, a sub-branch of EC, is to assess the equivalence of their standards with IFRS. Standards that are to be assessed are existing ones, which implicitly means reducing the differences between the standards related to the short-term as well as longer-term projects and IFRS are equally important.

As is well known, the CESR’s technical advice submitted in the summer of 2005 states that the accounting standards of Japan, the U.S. and Canada are on a par with IFRS taken as a whole. Upon this release, the CESR required remedial disclosure to each nation individually on issues that were different from IFRS. Japan was required to make disclosure on twenty-six issues, whereas the U.S. on nineteen issues, sixteen of which were common. As for Canada, fourteen issues were claimed to be different from IFRS, the fewest of the three. Of course this remedial disclosure was not intended to rank the standards, but it was intended to inform investors of the existing differences of the present individual standards and IFRS more clearly. However, because the regulation planned to be undertaken from 2007 had been postponed till 2009, we have to be ready for the new equivalence assessment, on the premise that further convergence will have been attained by then.

We want to emphasize that the process toward the convergence with IFRS and preparing for the equivalence assessment is not necessarily the same. In the long-run, they are the two sides of the same coin, but in the short-run, they require many different procedures. Despite this fact, we are expected to undertake these two projects simultaneously. Therefore, the ASBJ has decided to prepare for the reforms to Japanese accounting standards giving a priority on the twenty-six items for which remedial disclosure were required in the CESR paper released in 2005. Needless to say, this decision covers some short-term convergence projects.

Following this plan, we are ready to take the lead in the reforms of the longer-term projects as well. Especially we will give priorities to those items included in the joint project of the IASB and the FASB, which we believe, would contribute to global convergence.

### 3. Toward Convergence: Market Choice and the Role of the ASBJ

In this section, we briefly mention effects of convergence on Japanese system and how Japan is going to involve itself in this global project. As stated in the previous section, after WWII, Japan tried to modernize its market infrastructure by introducing and assimilating U.S. systems with the existing systems and laws in Japan. The Securities and Exchange Law and accounting standards are the good examples. To be more precise, we have been grafting an Anglo-American system on our former Continental system, where Commercial Codes had governed corporate disclosure since the industrial revolution (the Meiji Restoration) in the late 19th century[6]. In this way, we have experienced a sort of convergence, as it were, and have already caught up with the West in this regard.

Our history reveals that, in establishing market regulations of an Anglo-American type in the postwar period, we had to bring their essence in a way to meet the Japanese environment instead of simple adoption. It took a half-century for the Japanese system to be assimilated into the Anglo-American system, after going through a series of trials and errors. As described earlier, the process in which a social system evolves depends greatly on the way it has been developed. Therefore, it is hardly possible to implant a foreign system into a well developed society whose system has already been established. This holds true for the accounting system; it may be sensible to implant an international system into a country whose system has not been well established and hence the cost of transformation can be kept small, or whose market is so small and lacks an incentive to preserve its own system. However, the U.S. and Japan are the two countries where little of this is true.

Of course there would be no choice but to sweep away the existing system and introduce an entirely new system at once, as some may refer to as revolution, if the system were malfunctioning or corrupt, regardless of how well established the system has been. But when it comes to the internationally recognized markets, such as New York Stock Exchange (NYSE) and TSE, where their respective accounting standards are functioning well, not only the ultimate goal, but the process to reach that goal must be given careful consideration. It is not sensible to risk the entire existing system for achieving the imagined ultimate goal of convergence. This might not be a perfect example, but recall the case of the former socialist countries when they shared the goal in the formation of utopia. They all shared the same goal, but had alternatives to adopt in the process of achieving that goal; e.g., the Soviet, Chinese, and Yugoslavian models.[7] Such a pluralist approach to the goal is also useful to the capitalism countries where market environments including the legal framework vary.

What we emphasize here is that we should be rightly criticized for our “leap of faith”[8] if a country-specific route in which its system has developed is neglected in the course of

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[6] Commercial Codes had a series of amendments and now, codes that govern corporations are organized as Corporate Law.

[7] Of course many people still remember severe political battles among the former socialist countries over the process of achieving the goal. The fundamentalism had no tolerance for alternative principles, and the goal itself was based on an impractical cause, and hence invited demise of the system.

[8] See Ball (2005), p.24.

achieving the same goal with the rest of the world. It seems natural for countries that participate in European unified markets to share the unitary standards without any special treatment, but it is difficult to win the approval of participants of the U.S. and Japanese markets to unconditionally convert to IFRS. Therefore, we stress the importance of understanding why the existing national accounting standards function well in their capital markets, and then coming up with a sensible framework to facilitate the convergence toward the global standards.

In the Medium-Term Operating Policy[9] released by the ASBJ in 2004, the basic strategy toward the convergence consisted of two phases. The first step was to reduce the differences between standards as swiftly as possible in order to provide an environment for markets to support the existence of two (or more) sets of accounting standards at the same time. For this to be realized, it is necessary for both IFRS and Japanese GAAP to be accepted by markets of both the EU and Japan, so that the companies can choose standards for disclosing their financial reports. This scheme allows a competition of both standards within a sound market procedure, and leads us to the second phase where investors assess the quality of the standards and select those of high quality and low costs. This selection process would result in a further convergence. The role of the national standards setters at this point would be to improve the existing standards based on the evaluation of markets.

This strategy rests on the idea that both setting the national standards and converging them toward global standards should be determined in an incentive-compatible manner. It implies that the range of standards to be converged shall not be determined *a priori* by the standards setters, but instead it should be the result of the competition in the market where investors assess several reports based on different standards, and their assessments are reflected on the stock prices. Suppose a market allows disclosure of financial statements on several accounting standards. If investors judge one set of statements to be inferior to the others, they will presumably avoid the risk of investing their money on companies disclosing their statements on the inferior standards, and eventually raise the cost of capital for these companies. As a result, companies will stop using those standards. This process would encourage convergence on high quality global accounting standards.[10]

In order to have more than one set of accounting standards available, we need to shrink the differences among them, lest investors be confused. In fact, this is a necessary condition for the competition among several accounting standards, and the first step of the strategy proposed in our Medium-Term Operating Policy mentioned above is to satisfy the condition. Because the target of Japanese accounting standards is, needless to say, IFRS, the ASBJ has been making every effort to reduce the differences between these two standards obviously as an interim goal of the joint project with the IASB.

Of course formal reciprocal acceptance between EU and Japan is required for IFRS and Japanese GAAP to be recognized each other. The differences between standards will be gradually narrowing through investors' selection when both jurisdictions consider each other's standards equal in quality and reduce demand for remedial disclosure. This process

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[9] ASBJ, "Medium-Term Operating Policy of the Accounting Standards Board of Japan", July 15, 2004.

[10] If Japanese accounting standards are weeded out from the market through fair and sound market processes, then the participants of Japanese markets are left with no choice but to adopt accounting standards that have survived. But at the same time, we stress the importance of keeping Japanese accounting standards if any or all of them should survive the selection of investors in the market.

would induce sound and fair competition between standards in both markets. That is, the mechanism for convergence through market process will function as expected. The standards that are required of remedial disclosure will be amended *a priori* by the hand of national accounting standards setters or regulating bodies absent the adjustment in the markets. To avoid this to happen, we should not require too excessive remedial disclosure, unless there are major differences in the standards that need imperative reforms in order to protect investors from making crucial mistakes in their decisions.

The idea of putting emphasis on market competition may not always seem familiar to everyone, but this approach is not foreign to academic accounting researchers who have taken even an introductory economics course. For example, Shyam Sunder, in his often quoted paper (Sunder[2002]), argues that competitive standards setting, instead of monopolized one controlled by a single body, will help resolve the problem in an incentive-compatible fashion and advance the international harmonization (and even convergence) of accounting standards at a voluntary pace determined by local conditions.[11] In short, IFRS should be introduced into the U.S. as a complementary set of standards and be used as a device for the regulatory competition of standards in the U.S. financial markets.

It does not mean that there is no role for the national standards setters if the convergence is left to market mechanism. The above idea is often criticized mistakenly based on fallacious claims that this attempt is to abandon the whole convergence project. However, this type of criticism is made by those who are not familiar with an economic way of thinking. The idea, on the contrary, should be considered as a positive approach toward convergence.[12] Giving managers opportunities to select the standards they wish to use from the set of alternative accounting standards will eventually bring about profits and good reputations to the national standard setters supplying the standards that would meet the demand of the investors. This entire process gives an incentive for national standards setters to achieve the optimum degree of convergence of standards in the most efficient manner. The term optimum, however, does not necessarily imply a single set of standards. Multiple sets of standards in equilibrium cannot be logically excluded.[13]

Accounting standards are said to be codification of trading customs and contracts emerged in capital markets where information and funds have been traded through a series of innumerable (tacit in general) negotiations between investors and corporate managers. The intervention of the government concerning imperfect markets or incomplete contracts would work as a complement to market interactions, but in principle, the issues argued in this paper must not neglect market autonomy. Unlike the rules provided by criminal law, the rules regulating market economy are voluntarily accepted by those who are actually using them, and one has no incentive to deviate from the rules as long as everyone else is following them.

Unified standards (accounting standards are one of them) are appreciated simply because they have prevailed among many users, and due to this nature, some point out that markets are inclined to select standards that are currently used by many, and hence this tendency would hinder convergence with the optimum rule or keep the existing less desirable one. This is

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[11] See Sunder (2002), p.226. See also Dye & Sunder (2001), p.265.

[12] Sunder (2002), p.227.

[13] Refer to Sunder (2002), p.228, Ball (2005), and Watts (2006). See also Benston *et al*.(2006), Chap. 2~3.

what is generally referred to as network externalities.[14] A good example may be the competition of US GAAP and IFRS. Unless there exists a major difference in their qualities, it is most likely that US GAAP will always be the prevailing standards used in U.S. markets and IFRS in European markets. The same thing could be said for the competition between IFRS and Japanese GAAP. Although we cannot avoid this phenomenon in the short-run, global convergence on accounting standards may be something achievable in a much longer time span.

## 4. Obstacles to Convergence: What Information Is Useful?

At the outset of our project, we could not receive a broad understanding of the two-step approach for which we argued in the previous section: convergence as mutual recognition of accounting standards, and further convergence encouraged by the competition between standards in competitive markets. However, it seems that this approach has become a *de facto* framework of the joint project between IASB and the FASB. The issue is to what extent we can develop such a relationship between EU and Japan, or the U.S. and Japan. In order to achieve this goal, we need to realize reciprocity between EU and Japan by reducing the differences between their accounting standards. Unless at least two sets of standards are used in the same market and market players are given opportunities to choose the standard they prefer, the standards will not face the evaluation of the investors. This would lead the regulators to select a single-set of standards based on their *a priori* decisions.

As stated earlier, in order to have two standards coexist in one market we have been undertaking reforms to harmonize Japanese GAAP with IFRS. Harmonization with IFRS is undoubtedly important, but we stress that simply adjusting our standards to IFRS is not our goal of convergence. To be accepted by the entire world, IFRS should always receive feedback from market players including those in Japanese markets and constantly be revised. This paper is not intended to offer a reform plan to IFRS, but we address some essential concepts and discuss what can be done, specifically, what changes should be made or what can be added to IFRS, in order to delete the obstacles (if there exists any) in achieving convergence.

First and foremost we should consider the information content reflected in income, although it has been almost forgotten in pursuit of the assets/liabilities approach.[15] If our task is to define the elements of financial statements, it is a natural order to start from assets/liabilities and then to define income as a plug-in because the items that belong to the former are observable whereas income is a rather abstract concept. If this order is reversed, both assets and liabilities may include ambiguous factors inconsistent with empirical data,[16] since this approach is to define observable items (assets and liabilities) by means of unobservable factors. The changes in assets and liabilities are needed for recognizing income, and in this sense, there is no doubt in the primacy of the assets/liabilities approach.

However, this statement is not synonymous to saying the income that is derived as a result of recognition of assets and liabilities (so-called comprehensive income) would be useful for

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[14] Katz and Shapiro (1985).

[15] The term income is meant to imply the net concepts, such as what is left after subtracting expenses and loss, and does not imply any gross concepts such as revenue or gain.

[16] This is often referred to as “what-you-may-call-its”.

investors in determining their decisions. Any income concept should be related to the changes in assets and liabilities, but something more is needed. The current reporting system has been dealing with this issue by using the concept of net income (or earnings).[17] It is not rigorously defined, but empirical research to date has revealed that it contains relevant information in a sense that it explains the fluctuations of stock prices. Therefore, they are conceived as indices that cannot be replaced with the concept of comprehensive income.[18]

Even if comprehensive income is not compared with net income, it is intuitively clear that there is no strong correlation between the former and the value of the corporation. Comprehensive income is an increase in net assets during the accounting period, which is automatically derived from the balance sheets at the beginning and end of the period, unless equity transactions exist. In short, the concept does not convey anything more than the information contained in the balance sheet. Therefore, whether it can be a good proxy for the corporate value or not depends on the relation between the amount of net assets and aggregate stock price; in other words, the responsiveness of the stock price on the changes in net assets, or the stability of PBR (price-to-book ratio), is what matters.

In order to keep the level of PBR stable, the amount of net assets and the market value should always move in the same direction maintaining the same ratio if possible. The market value equals the sum of on-balance net assets and off-balance goodwill. Hence, if the market value moves together with the amount of net assets, it means the on-balance and off-balance values are positively correlated. Let us consider the case in which property prices rise and its writing-up is allowed. Because the stock price depends on the expected performance of the business in the future, there would be no increase in the stock price in tandem with the property prices if the expectation is low.

Therefore, neither the amount of net assets nor the amount of comprehensive income, which is the mere difference between the beginning and the ending net assets, is useful for investors in estimating the corporate value. Just defining and measuring assets and liabilities, even if done precisely, is not sufficient to provide useful information about the future performance of the company. Because internally generated goodwill is part of corporate value, but kept off-balance, it is not linked with the rest of the corporate value that appears on-balance. Then, neither net assets which are entirely based on on-balance items nor comprehensive income that is derived automatically from them will serve as useful information in estimating the off-balance value.

As Beaver [1981] points out, if the market is perfect and complete, net assets and market value move in lockstep and either net assets or comprehensive income could convey the same message to every investor.[19] In a world where there exists no off-balance corporate value, all assets and liabilities will always be recognized on-balance and evaluated in the market, and the higher net assets or comprehensive income, the higher stock price. In such a case, there is no need to disclose information on net income in addition to comprehensive income. Moreover, there is no need to disclose any accounting information let alone income. The fair value of each asset and liability determines the corporate value.

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[17] We may consider net income and earnings to be practically the same. See SFAC, No.5, para.34.

[18] Interested readers are referred to Barth (1994); Bernard, Merton & Palepu (1995); Barth, Beaver&Landsman (1996); Dhaliwal, Subramanyam & Trezevant (1999); and Aboody, Barth & Kaznik (1999). Obinata (2002) provides comprehensive surveys on this matter including all these papers.

[19] Refer to Beaver (1981), Chap.4.

Accounting information is useful in a world where the market is imperfect or incomplete and hence some of the intangible value of the company is not traded separately from the rest of the intangible and tangible assets of the company. In other words, this is a world where part of the intangible assets has fallen off the balance sheet and hence the corporate value cannot be measured by simply evaluating on-balance assets and liabilities. In such a market, disclosure of accounting information is required to enable investors to assess the value of goodwill at their own risk. Net income is a concept obtained through trial and error that has emerged in the process of searching information relevant to investment decision. What is important is not the reported amount of net income itself based on the present standards, but what lies behind it.

In the ASBJ's discussion paper on conceptual framework, we propose that net income together with comprehensive income be presented following SFAC No.5 issued by FASB. We define it as an outcome that is released from investment risk which reflects uncertainty in the future and disappears when the expected outcome unfolds. When to recognize the release from risks depends on the nature of investment. If the investment has been made to expect future cashflow, the risk disappears when cashflow is realized; and if investment is made to expected price appreciation, the risk disappears when the market price changes based on the premise that the fluctuation in the price is cashflow.

Receiving feedback on their prior (*ex ante*) information from their *ex post* information, investors continue to update these priors and reassess the corporate value. Investment decision is a process of updating the priors and acting based on such updated priors (posterior information). All they need here is an *ex post* measure of outcomes, i.e., factual information that can be compared with a prior one to update the amounts and uncertainties of outcomes expected *ex ante*. It would be a huge step forward to convergence of Japanese GAAP and IFRS if we could build a scheme to include such an investment outcome on the financial statements.

## 5. Learning from the Past: Comprehensive Income and Windfall

In this section we focus on the difference between comprehensive income and net income, and its adjustment. As it is clear in the present IFRS and US GAAP, what is included in net income of a particular period is what has been recognized as comprehensive income in the same period or before. Nothing can be recognized as net income without being recognized as comprehensive income. Any item included in comprehensive income but excluded from net income, the so-called other comprehensive income (OCI), will be reclassified as net income only when it satisfies certain conditions. It is often referred to as recycling. This rule requires both comprehensive income and net income to coexist on the financial statements, while net income and comprehensive income would never appear simultaneously without it.

OCI and recycling have become popular in accounting standards only recently, but they have their roots in the traditional argument on "what is income". As is well known, income as a surplus after maintaining capital intact is a variation between the beginning and end of the period with the value of capital being a function of the expected future outcomes. However, if we applied this concept mechanically, income would include a windfall element due to the change in the expectations, because the information one faces at the beginning and end of the period is different and hence the expected payoff formed at each stage differs. We would not obtain a proper signal from income, unless we exclude this windfall by making the expectation fixed at either of the beginning or end of the period.[20]

In economic analysis, the index of income is considered useful if it can measure “the value of the increase in capital”, rather than “the increase in the value of capital”. Unexpected windfall gain is a mere revision of valuation of the existing wealth of a person rather than a measure on how much better off he or she has become within a particular period. Although it may be counted as income of a certain period, the asset is not associated with any particular period during its lifespan. In case of capital assets, the current practice of mechanical depreciation based on original cost is a way of spreading windfall elements (without excluding them from income) over their useful life.[21]

OCI corresponds to this windfall. Because OCI is a zero-mean random variable *ex ante*, the average of each year’s gains and losses booked to OCI is zero, and its expected accumulation in the future is zero as well. It automatically disappears once the outcome is realized *ex post* replacing its expectation held *ex ante*. In accounting practices, this windfall portion is excluded from net income and instead classified temporarily as OCI, then recycled into net income upon its realization. The balance of OCI thus converges to zero as *ex ante* expectation is realized *ex post*. What is argued from a viewpoint of economics is close to an existing accounting standard: income should not be directly calculated from the difference of capital between the beginning and end of the period, but exclude windfall as OCI to be recycled into income once it satisfies certain conditions.

The attempt to fill in the gap between economics and accounting as stated above goes back to the concept of “variable income” proposed by Alexander (1948) published in *Five Monographs on Business Income* under the auspices of the American Institute of Accountants (AIA). This concept has attracted much attention since it was reexamined by Solomons (1961). In simple words, it measures capital at the end of the period by classifying it into two categories, i.e., net cash equivalent and the remaining non-cash items, and evaluates the value of the latter based on the expectations at the beginning of the period whereas the value of the former is evaluated by the realized outcome. Of course, capital at the beginning of the period is measured on its expected value. As a result, the windfall caused by the variations of expectations regarding non-financial investments is excluded from income and only goes back into income once the cashflow is realized.

Nowadays few attempt to examine several concepts of income theoretically, since this line of research has been out of favor due to the “paradigm shift” in the academia of accounting. Some of them, however, are properly reflected in current accounting standards because they are believed to provide useful information regarding income, which otherwise could not be provided merely through the balance sheet presenting assets and liabilities with their respective fair values. In Japan, until about a half-century ago, Commercial Codes required two types of balance sheet; one is what we consider the balance sheet today and linked with income determination, whereas the other, the inventory list of properties, was intended to provide information on the value of individual assets and liabilities but unrelated to periodical

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[20] See Lindahl (1933), Hicks (1946), Kaldor (1955), although Hicks seems to treat the income *ex post* as the concept which includes windfall.

[21] See Alexander (1948), p.5.

income. The latter has been abolished as insignificant, but if necessary, we could revive it lest the balance sheet should disturb useful information contained in income.

## 6. Concluding Remarks

We have stressed the significance of global convergence for Japanese accounting standards. It goes without saying that IFRS should be the target for Japanese GAAP. This recognition is reflected in the ASBJ's tremendous efforts on the joint projects with the IASB. Convergence encourages the development of new standards and/or their adjustments in a way that would meet the demand of the users all over the world, specifically participants in global markets including Japan. From this viewpoint, Japan will actively disseminate suggestions and comments to the accounting standard setters of the world including the IASB, which will lead to convergence on high-quality accounting standards. To do materialize this mission, we will constantly update our proposal (Discussion Paper of the ASBJ, December 2006) on conceptual framework, which reflects the majority views of interested parties in Japan.

One of the most important issues in achieving global convergence is to develop the method for conveying information on income which is vital for investors to make expectations about the future and the corporate value, in addition to information on assets, liabilities, and comprehensive income. Although income is the result of recognition of items on the balance sheet, we should not recognize income merely as a result of changes in assets and liabilities. Neither should we recognize assets and liabilities as a result of income recognition. While some argue that information content in income has been decreasing, empirical evidence shows that when considered together with net assets, income continues to provide useful information to the market.[22] It may as well be said that whether the convergence of Japanese GAAP and IFRS make rapid progress depends on how well the index corresponding to net income can be developed.

In their joint project, the IASB and the FASB have tentatively agreed on eliminating the presentation of net income in the long run. But, given that empirical evidence has shown a strong relation between information on net income and stock prices, we cannot deny the relevance of the information to investment decision. Although its impact on investors' decision is also the reason for widespread earnings management, whether the presentation of net income be abolished should be left to the market. Even if we eliminated the concept of net income from accounting standards, similar information would become available as *pro-forma* information. In other words, it would create a sort of black market. From the viewpoint of lawyers, black markets are black, but from the viewpoint of economists, any market, black or white, is a market nonetheless. The IASB is expected to take the lead on this issue lest such information should become prevalent through a loophole in standards.

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[22] For example, Collins, Maydew & Weiss (1997).

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