Advances in Japanese Business and Economics 6

Kunio Ito
Makoto Nakano *Editors*

International Perspectives on Accounting and Corporate Behavior

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Advances in Japanese Business and Economics 6

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International Perspectives on Accounting and Corporate Behavior

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Preface

With the rapid globalization of the world economy, accounting standards are gradually being integrated and are increasingly resonating with one another. Of the issues this process has created, convergence to International Financial Reporting Standards (IFRS) is one of the most controversial and is the subject of increasing interest in both financial accounting research and practice. Despite the push towards convergence, accounting rules in individual countries remain deeply intertwined with their unique institutions, such as corporate and economic systems and legal practice, i.e., "enforcement." The approach of *New Institutional Accounting* is to analyze the economic consequences of converging accounting rules by focusing attention on each country's conditions and historical path. This empirical book uses the above-mentioned approach to conduct research on convergence in Japan.

Despite the globalization of accounting standards occurring through convergence to IFRS, every country retains local aspects in its institutions. As a result, for each country an individual mix of global and local factors determines the economic consequences or relevance of the convergence of accounting standards or the adoption of IFRS. Thus, the information value of accounting standards is a complicated mix of these factors. This concept underlies the present work.

This book investigates the differences between IFRS and local (particularly Japanese) accounting standards from the point of view of earnings property and their economic consequences. In particular, the authors empirically analyze the effects of convergence upon Japanese firms' corporate investment behavior and dividend payout policies.

Based on the evidence of economic consequences, this book provides empirical implications for global accounting standards setting. The International Accounting Standards Board (IASB), which developed IFRS, recently has tended to listen to feedback from individual countries in order to improve the quality of IFRS. This book attempts to articulate the issues encountered in the globalization and localization of accounting standards.

A further dimension is also explored in this volume. Despite the globalization of accounting standards, each country continues to have its own corporate disclosure

systems or regulations, regardless of whether they are mandatory or voluntary, because securities administration systems and corporate governance standards lack convergence or a common model like IFRS.

The latter part of the book identifies the inherent characteristics of disclosure behavior by Japanese firms and empirically diagnoses its effects on corporate behavior and capital market.

The authors are consistent in terms of research methodology, issue awareness, and motive. As the contributors and editors have held workshops on numerous occasions, their experience and enjoyment in sharing exciting and simulating issues have been helpful. Without them this outcome would not have been achieved.

Many people have assisted us in editing this book. One of the editors, K.I., especially acknowledges Ryuzo Sato (New York University), who invited him to be a member of the editorial board of the Advances in Japanese Business and Economics series and provided inspiring comments. Publishing this book would not have been possible without his encouragement. K.I. thanks Bill Beaver (Stanford University), who welcomed him as a Fulbright research fellow and is his role model. He also acknowledges Baruch Lev (New York University), who encouraged him to publish the outcome of his research in English as soon as possible.

Kunitachi, Tokyo, Japan

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Makoto Nakano

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Framework and Overview

Kunio Ito

Abstract This chapter explains the background, motive, and analytical framework as well as the underlying notion adopted in this book. Convergence to International Financial Reporting Standards (IFRS) is one of the most controversial issues and is the subject of increasing interest in both accounting research and practice. Despite the push toward convergence, accounting systems in individual countries remain deeply intertwined with their unique institutions, such as corporate and economic systems and legal practice, i.e., "enforcement." As a result, for each country, an individual mix of global and local factors determines the economic consequences or relevance of accounting standards convergence. Based on the evidence of economic consequences this book intends to provide empirical implications for a global accounting standards setting. A further dimension is explored in the volume. Despite the globalization of accounting standards, each country continues to have its own corporate disclosure systems or regulations, regardless of whether they are mandatory or voluntary, because securities administration systems and corporate governance standards lack convergence or a common model like IFRS. We make attempts to identify the inherent characteristics of disclosure behavior by Japanese firms and empirically diagnose its effects on corporate behavior and capital market in terms of enforcement unique to Japan.

Keywords Accounting standards • Convergence • Corporate system • Earnings attributes • Enforcement • IFRS • Management forecast • Risk disclosure

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1 Part I: Earnings Attributes and Corporate Behavior

1.1 The Trend Toward Global Convergence of Accounting Standards

This book consists of two parts. In Part I, the relationships between accounting standards and corporate behavior are analyzed. In conjunction with the globalization of corporate accounting, accounting standards in various countries have changed greatly. To begin with, what role did the accounting system play in Japan? Furthermore, how is the above-mentioned transformation of the accounting system affecting corporate behavior? Part I investigates the types of economic consequences being generated by the progress in the global convergence of accounting standards and how this trend is changing corporate behavior.

Since the middle of the 1990s, the globalization of corporate accounting has progressed at a bewildering speed. Reforms in accounting standards have advanced rapidly in Japan as part of a series of responses to the so-called Financial Big Bang in Japan—a term that refers to the globalization of Japan's capital markets. The country has made significant progress toward globalizing its accounting standards. As part of its economic integration, the European Union (EU) resolved to mandate the adoption of International Financial Reporting Standards (IFRS) ahead of other countries and regions in order to integrate the corporate accounting underlying the economy. Developing countries that lack mature accounting standards have also actively adopted IFRS as part of the establishment of systems to support their economic foundations. This trend has been accelerated by the fact that the introduction of IFRS has been one of the conditions imposed by the International Monetary Fund (IMF) in order to receive financing.

Initially, the United States, which is proud of the quality of its own accounting standards, did not respond positively to this trend toward the global integration and convergence of accounting standards. However, following a series of accounting scandals at the start of the 2000s, the U.S. had no choice but to steer a course toward the global integration and convergence of accounting standards. The Financial Accounting Standards Board (FASB) is the organization that determines accounting standards in the U.S., and the International Accounting Standards Board (IASB) is the organization that formulates the IFRS. In September 2002, FASB concluded the Norwalk Agreement with IASB, and both parties agreed to work together to determine the highest, globally comparable accounting standards and have since been working together toward this goal.

The trend toward global integration and convergence was further accelerated by "equivalence assessments" implemented by the Committee of European Securities Regulators (CESR) beginning in the middle of the 2000s. The EU announced that it would require companies from outside the EU region that were raising funds within the region to prepare financial statements based on IFRS or on accounting standards recognized as being equivalent to IFRS. Therefore, in 2005 the EU requested that

the CESR assess and identify whether certain accounting standards—such as those of the U.S and Japan—were equivalent to IFRS. This approach put substantial pressure on the relevant parties and accelerated both global integration and the convergence of accounting standards. Hence in 2007, the U.S. recognized the adoption of IFRS by foreign companies, and since 2010, Japan has also begun to recognize the voluntary adoption of IFRS by listed companies.

However, there have been signs observed in recent years that this trend is starting to change. The U.S. had scheduled a resolution for 2011 on whether the adoption of IFRS would become mandatory. However, based on interviews with a large number of interested parties, the Securities and Exchange Commission (SEC) found in its final staff report published in July 2012 that interested parties in the capital markets did not support the wholesale incorporation of IFRS into the U.S. system. However, it also found that the U.S. was committed to the objective of formulating unified, high-quality global accounting standards and that proposals to examine other ways of introducing IFRS had received a great deal of support. The SEC indicated that there were still many problems to be overcome before introducing IFRS. Among these were the possibility of its adoption in regulations for public-interest industries, the regulatory environment in terms of tax law and corporate law, the possibility of audits, and the effects of IFRS on agreements among individual companies. In particular, accounting information in the U.S. is rooted in various agreements and regulations, and concerns were expressed that the U.S. system would be converted from being "rule-based" to being "principle-based." This concern has been a very large obstacle to IFRS adoption.

Furthermore, these problems are not limited to the U.S.: sufficient progress is yet to be made in China and India toward global integration and the convergence of accounting standards. Moreover, countries such as Malaysia and Indonesia are investigating ways to "carve out" certain parts of IFRS in their accounting standards. Even in recent years, Europe was a forerunner in the mandatory adoption of IFRS for listed companies. However, in more recent years, there have increasingly been questions on whether IFRS is consistent with even the accounting standards of European countries. The trend toward the global integration and convergence of accounting standards is approaching a turning point.

Japan has continued its convergence with IFRS. As part of this process, on June 20, 2013, the Financial Services Agency and the Business Accounting Council published the Interim Policy Relating to IFRS (subsequently, the "Interim Policy"). A new approach was advocated in this Interim Policy regarding the "establishment of an endorsement process that allows for each [IFRS] standard to be individually reviewed and, if necessary, parts to be deleted or amended." In other words, it has decided to adopt an "endorsement approach" (as the procedure to incorporate IFRS into Japan's own standards), in which not all of the IFRS standards would be adopted. Under the approach on the basis of consistent judgment criteria, some standards would be adopted and others deleted or modified (i.e., a "carve out"). In other words, IFRS would be endorsed from the perspective of how appropriate it would be for Japan. It means that the formulation of J-IFRS as a Japanese version of IFRS has also been proposed.

Changes have also started to appear in the IASB's posture on formulating IFRS. In order to formulate accounting standards that would be preferable in the sense that they incorporated the "voice" of each country, the Accounting Standards Advisory Forum (ASAF) was established as a new framework to facilitate cooperation between the IASB and the organizations responsible for setting accounting standards in each country. Its establishment is highly significant within the flow of events toward the global integration and convergence of accounting standards. Twelve countries and groups are members of ASAF, including the Accounting Standards Board of Japan (ASBJ). Some of these members, including Japan, also sit on the Monitoring Board which monitors the IFRS Trustees and each country through the ASAF (which is held four times a year) explains its own position and opinions. This is expected to contribute to the preparation of IFRS. When expressing opinions to the IASB, it is important that the impact or effect of IFRS adoption on corporate behavior and competitiveness be empirically verified. Against this backdrop, this report offers empirical evidence regarding the situation in Japan in a global context.

1.2 Economic Consequences of the Adoption of IFRS

What economic consequences, i.e., effects, are being produced by this trend toward the global integration and convergence of accounting standards? Here, based on the classifications of Brüggemann et al. (2013) and Hail et al. (2010), the effects have been divided into three categories: (1) effects on capital markets and macroeconomics, (2) effects on the attributes of accounting data, and (3) effects on contract agreements and investment/distribution operations.

A number of studies on capital markets have investigated the effects of IFRS introduction on the liquidity of stock markets and the cost of equity capital; these effects have been verified to be positive in general. Specifically, it was discovered in previous research that liquidity in stock markets increases with the introduction of IFRS (Daske et al. 2008), that the bid–ask spread decreases (Muller et al. 2011), and that the cost of equity capital decreases (Li 2010). Moreover, Florou and Kosi (2013) found that after introducing IFRS, companies saw a reduction in the yield spread of their bonds, suggesting that its introduction even provides benefits in bond markets. In addition to investigating the direct effects of IFRS on capital markets, research has also investigated its indirect effects on analysts' behavior. It was observed that after a company introduced IFRS, there was an increase in the number of analysts tracking it, and also an improvement in the accuracy of their forecasts (Landsman et al. 2012; Tan et al. 2011).

As shown above, research into capital markets has verified the micro-level economic consequences of introducing IFRS. However, in recent years, verifications have been carried out at the macro level in addition to research verifying its micro-level effects. For example, Khurana and Michas (2011) discovered that after the introduction of IFRS, the home bias of U.S. investors decreased. Furthermore,

Beneish et al. (2012) found that investment in overseas credit increased in countries where IFRS was introduced.

As described above, research into the capital markets has verified that the introduction of IFRS has generally positive economic consequences. However, it is important to be aware that the above findings cannot be generalized to all countries. For example, Daske et al. (2008) found evidence suggesting that liquidity in the capital markets increases following the introduction of IFRS. However, it has been reported that this capital-market effect has been observed only in countries where enforcement of laws and regulations is comparatively strong and where the institutional environment provides incentives for companies to try to be transparent. Moreover, Shima and Gordon (2011) found that there is no evidence that equity investment from the U.S. increases in countries where IFRS has been introduced; they did, however, discover that equity investment rises in the event that the introducing country strongly enforces its laws and regulations. These kinds of verified findings can also be seen in other prior research. In other words, the consequences of IFRS introduction on capital markets in a country will depend on the extent to which the laws and regulations are enforced.

Next, the consequences for accounting information attributes are considered. Much of the research in this area has verified the effects that the introduction of IFRS has had on the comparability of accounting information as well as earnings quality obtained from accounting information. However, the evidence provided by this body of research has generally lacked consistency. Concerning comparability, Yip and Young (2012) discovered evidence indicating that nations where IFRS was introduced observed improved comparability of financial statements. This was slightly contradictory to the findings of Liao et al. (2012), who investigated French and German companies. Liao et al. (2012) found that the comparability of French and German companies improved immediately after the introduction of IFRS. However, they also reported that this effect was not observed at a later time. Additionally, Kvaal and Nobes (2010) investigated whether accounting policies became unified in countries where IFRS was introduced. They observed systematic differences among these countries and reported that although such differences did exist beforehand, the introduction of IFRS did not seem to unify their accounting policies.

The findings presented by research focusing on earnings quality have also been complex. Barth et al. (2008) verified the earnings quality of companies that reported their accounts based on International Accounting Standards (IAS) compared with those that used domestic, generally accepted accounting principles (GAAP) in their reports (the latter were non-U.S. countries). Barth et al. (2008) reported that companies whose reports were based on IAS showed fewer tendencies to smooth their earnings than those companies using domestic GAAP and recognizing losses in a timely fashion, which led them to conclude that earnings quality improved with the introduction of IAS. However, Ahmed et al. (2013) presented evidence to the contrary. Specifically, on comparisons with benchmark companies, they reported that IFRS companies more frequently used earnings smoothing and did not recognize loss at appropriate times. With regard to this difference between the

verification results of Ahmed et al. (2013) and Barth et al. (2008), the latter assessed companies that had voluntarily adopted IFRS; hence, their findings may have been affected by this voluntary selection bias. However, Chua et al. (2012) examined companies in Australia, where the adoption of IFRS is mandatory, and reported that after the introduction of IFRS, earnings smoothing among Australian companies did not occur—and that loss was also recognized in a timely fashion. Therefore, we cannot be certain that the bias of voluntary selection was necessarily a factor in the verification findings of Ahmed et al. (2013) and Barth et al. (2008).

Hence, we can see that the evidence presented by research into accounting information attributes is not necessarily consistent. The introduction of IFRS may indirectly affect individual agreements (such as compensation for executives and restrictive financial covenants), dividend regulations and the taxation system, and industry regulations or agreements. However, there is still a paucity of research on the effect of IFRS on the behavior of company executives, who are accountable to shareholders, in terms of investment and distribution (dividends). For instance, Li (2010) discovered that following the introduction of IFRS, the cost of shareholders' equity significantly decreased. Conversely, Daske et al. (2008) reported that they found no significant changes in the existing corporate values (Tobin's q) of companies after the introduction of IFRS. The findings of these two studies indicate that the introduction of IFRS simultaneously decreases capital cost and cash flow, with capital cost as the denominator and cash flow as the numerator in the corporate value equation. In other words, they suggest that companies may lose competitiveness following the introduction of IFRS. The global convergence of accounting standards is also likely to affect corporate behavior, starting with a company's capital investment.

The majority of these verifications suggest that enforcement differences in each country and the resulting differences in stakeholder incentives have major effects on the consequences of IFRS introduction. For example, Ahmed et al. (2013) and Verriest et al. (2013) presented evidence suggesting that systemic factors determine whether or not comparability and earnings quality improve following the introduction of IFRS. In addition, changes in the extent to which comparability and earnings quality improve can be determined by these factors. Christensen et al. (2013) document an increase in research using international comparisons and other methods in attempts to clarify the influence that these incentives and enforcement have on the economic consequences of mandatory IFRS introduction.

1.3 Incentives and Enforcement for Financial Reporting by Japanese Companies

What are the characteristics of the incentives and enforcement for financial reporting by Japanese companies? Below, we clarify these characteristics while comparing them with those in the U.S. and Europe. It is possible to investigate the

Table 1 Ratio of top executives whose compensation is above 100 million yen (about 1 million U.S. dollars)

	Japan	U.S.	Europe
Total compensation (%)	1.52	16.98	15.97

Table 2 Number of mergers and acquisitions

	Japan	U.S.	Europe
Number of M&A	1,291	5,175	4,251

factors determining incentives for financial reports from a variety of aspects. Here, however, we analyze the differences in terms of executive compensation.

Table 1 shows the ratios (as percentages of all listed companies) of companies that employ top executives whose yearly compensation is 100 million yen or more. Capital IQ from S&P was used, and actual conditions of compensation for executives in Europe, Japan, and the U.S. (i.e., developed countries) were investigated. From the table, we can see that in comparison with the U.S. and Europe, where slightly less than 20 % of companies employ top executives with compensation of over 100 million yen, only 1.5 % of companies in Japan employ such highly paid executives. Previous research has shown that in the majority of cases, executive compensation is tied to a company's earnings performance and stock price; in other words, compensation tends to be related to how a company manages its earnings. Hence, compared with Japan, it is more necessary to orient company performance to restrict the potential for executives to manage their company's earnings in the U.S. and Europe.

Table 2 shows a comparison of the number of cases of company mergers and acquisitions (M&A) in the countries and regions under comparison. Capital IQ from S&P was used, and published data on the number of M&A was referenced. In addition, it was possible to confirm that compared with Japan, companies in the U.S. and Europe are more actively carrying out M&A, and more companies record net losses. This mostly reinforces the tendency for valuations to depend on fair values in company balance sheets. Hence, it is very possible that this creates an environment susceptible to introducing accounting systems based on the fair values of balance sheet assets and liabilities, or other fair value corporate accounts

Next, the extent to which each country and region invests its resources to thoroughly enforce laws and regulations in its security markets was investigated. To this end, we calculated the investment made by each country and region in terms of the number of staff per one million people and the budget amount per one billion dollars of GDP with reference to Jackson and Roe (2009). For Europe (23 countries of which were considered for this research), these totals were calculated based on numerical values weighted according to the respective country's population and GDP. As shown by the results in Table 3, the U.S. invests a large amount of resources as is required by its Securities and Exchange Law, whereas Japan's investment is at a low level even when compared with that of Europe.

Table 3 Resource-based securities law enforcement data: staffing/population and budget/GDP

	Japan	U.S.	Europe
Number of staff per 1 million people	4.32	23.75	9.14
Budget amount per $1 billion of GDP	15,754	83,232	45,166

Table 4 Corporate longevity

	Japan	U.S.	Europe
Number of years since establishment (average)	61.1	33.7	53.8
Ratio of companies established 50 years ago or more (%)	60.7	18.0	34.6

Hence, we can conclude that company executives in the U.S. tend to be opportunistic in carrying out earnings management affecting their own compensation. Also, the large number of companies recording a loss and the relatively larger number of M&A indicates a high likelihood of its accounting system being orientated toward a high level of transparency. Moreover, since it is difficult for financial reporting based on the introduction of such accounting systems alone to create sufficient economic impact, it can be confirmed that the U.S. adopts the approach of investing a large amount of resources for the thorough enforcement of laws and regulations in its security markets. Conversely, in the case of Japan, there has not been a strong tendency from the beginning for company executives to engage in opportunistic earnings management for the purposes of boosting their own compensation, and the ratio of companies recording a net profit in the country is high. Meanwhile, we can confirm that Europe's position lies between those of Japan and the U.S.

Japanese companies also tend to survive longer than their U.S. and European counterparts (Table 4). The U.S. aims to develop its companies and economy through the dynamism of its markets while promoting the activity of its security markets, such as through compensation for executives and M&A. However, Japan aims to develop its companies and economy through stakeholders that support companies and the construction of long-term-orientated accounting. Hence, it places importance on the ongoing existence of its companies. Therefore, rather than focusing on achieving highly transparent earnings performance, Japan tends to be oriented toward earnings smoothing and matching costs with revenue for enabling long-term performance trends, and it adopts conservative accounting practices for highly uncertain future events.

1.4 Analytical Framework of Part I

In conjunction with the progress being made toward international integration and the convergence of accounting standards, the differences in accounting standards between countries and regions are gradually shrinking. However, we have seen that

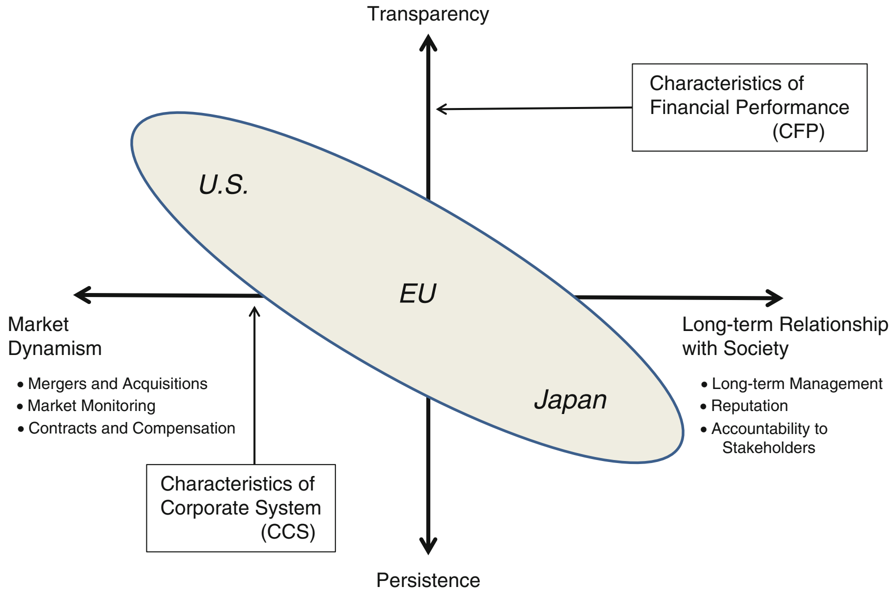

Fig. 1 Analytical framework of Part I

changes are not taking place rapidly and that each country's system has its own path dependent upon (1) attributes for corporate performance and earnings in each country and region, (2) the incentives that support these attributes, and (3) the power to enforce laws (enforcement). Therefore, although the globalization of accounting standards is progressing, local aspects are being maintained in accordance with economic and institutional factors specific to each country. In other words, the global convergence of accounting standards is yielding complicated and mixed outcomes as a result of both global and local factors in each country—a notion underlying the book. This book takes on the challenge of investigating this theme.

"New Institutional Accounting"—a new paradigm of empirical research-oriented approach currently coming to prominence—is based on the idea that convergence of accounting standards does not produce uniform or simple outcomes, and that its economic consequences are inevitably influenced by country-specific economic and institutional factors (Leuz et al. 2003; Hail and Leuz 2006; Leuz 2010; Wysocki 2011). This volume has constructed an analytical framework based on the same assumption (Fig. 1).

We compare the above-mentioned incentive structure and the characteristics of enforcement and classify them into patterns, following which we place the characteristics of corporate systems (CCS) on the horizontal axis and the characteristics of financial performance (CFP) on the vertical axis: for each of these factors, the international characteristics of the mechanisms used to regulate corporate activity in each country and region become apparent. In the U.S., for CCS, we see that

dynamics established from market principles are at work. As a result, M&A frequently take place, monitoring by the markets is strong, and compensation for executives is closely linked to stock prices and earnings performance. Consequently, the "survival of the fittest"-type struggle among U.S. companies is fierce, as a result of which their average lifespan is comparatively short. To allow these kinds of market dynamics to function, a high level of transparency is required as a CFP.

However, the dominant corporate system in Japan differs from the system followed in the U.S. Iwai (2009) states that capitalism is not monolithic and explains how capitalism in the U.S. is different from that in Japan. Iwai notes that Japanese companies tend to place more emphasis on employee benefits and welfare rather than profit margins that directly benefit shareholders. The goal of Japanese companies has been to ensure long-term corporate growth.

Itami (2010) insists that the corporate system is the linchpin between knowledge and innovation and has identified two types of corporate systems: the market-oriented corporate system and the organization-oriented corporate system. In the market-oriented system, the market mechanism is central to the resource allocation across the economy. On the other hand, the organization-oriented corporate system is one where an organization mechanism performs the resource allocation for the economy. The market mechanism involves "the pattern of transaction where individual economic units consider only their self-interest and decide which party to transact with and how much to transact at what price freely without command from some other party" (Itami 2010, p. 17). In contrast, in the organization mechanism, resources are allocated and people organized via coordination by the organizational sphere. The evidence squarely indicates that Japan can be characterized as an organization-centered system, while the U.S. is a market-centered system, although any country will ultimately be a complicated mixture of these two mechanisms. Based upon the organization-centered corporate system, Japanese management upholds the principle of enhancing the corporations' long-term growth and prioritizing employee interests rather than those of stockholders.

These views, as well as the above-mentioned data and evidence, suggest that Japanese companies tend to place strong emphasis on sustainability and seek to establish enduring relationships with society, i.e., management has a long-term outlook. In other words, Japanese companies are accountable not just to their shareholders but also to other stakeholders, such as employees banks, and suppliers. Hence from an international perspective, the compensation paid to executives of major Japanese companies is usually low. A company's sustainability depends heavily on its reputation and level of trust from society. If a company loses trust, it will find it difficult to maintain its operations. Accordingly, Japanese companies tend to despise volatilities in earnings in favor of maintaining continuity from the CFP standpoint.

As demonstrated above, the underlying mechanisms that affect corporate activity in Japan and the U.S. are highly contrasting. To classify Europe in a similar fashion, its position can be assumed to be between those of Japan and the U.S.

Based on the above frameworks, Part I of this book investigates relationships between corporate behavior and accounting phenomena such as (1) the revenue and