

International Comparison with a Focus on the Structure of Accounting Regulation : Discussion of a Possible General Framework for International Accounting Harmonization.

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OBJECTIVE OF THE STUDY

The principal objective of this paper is to present a critical overview of accounting regulation in Japan as well as to propose a general framework of accounting regulation through which to compare structures of regulation across the developed capitalist world. The author believes that an analysis of the structure and functions of Japanese economic development and business growth, since accounting practice and the underlying accounting regulation have played an important part in enabling Japanese business to accumulate capital at breakneck speed and in allowing the economy to grow at phenomenal rates. The author also holds that such an analysis will be instrumental in discerning the role of accounting regulation in a broader arena involving the state, the economy and the civil society. The present paper is intended to advance this aim, drawing on the work of academics identifying with a broadly defined critical school of accounting in Japan.

The paper is organized as follows. The first section outlines and contrasts the concepts of accounting regulation typically employed in Western and Japanese research studies. The second section presents a possible general framework for comparative analysis of accounting regulation, consisting of the state, the economy and the civil society. The third section explains the structure of Japanese accounting regulation focusing on the legal framework underpinning that structure and the dual regulatory framework that developed in post-war Japan.

Attention is directed towards the organizational structure of the regulatory machinery in Japan and to the impact of this on accounting regulation in practice. The fourth discusses the principal factors leading to the current primacy of public regulation in Japan, and the final section entitled "Prospects" presents the authors' views on the future direction of regulation in Japan.

1. AN EXAMINATION OF THE CONCEPT OF ACCOUNTING REGULATION : TOWARDS A BROADER SCOPE OF RESEARCH

Before discussing the nature of accounting regulation in Japan, the concept of regulation

adopted in research studies conducted in Western nations is contrasted with the concept adopted in Japanese studies. Termed in this paper an accounting regulation concept,¹ the concept adopted in the West embraces such issues as the relationship among the political, economic, social and environmental factors bearing on accounting and the interplay of regulation and regulation avoidance that unfolds among organizations and groups with conflicting interests.

The approach covers a whole spectrum of issues related to the regulatory process. These issues range from the setting of accounting standards (legislative or otherwise) and their enforcement, to the assessment of their economic consequences. Other concrete issues falling under the scope of this concept include the identity and nature of the regulatory body (private or public sector); regulatory objectives to be advanced (such as the choice of economic and social interests to be served or the trade-off between private and public interest); method or means of regulation (whether to regulate, for example, through mandatory legal requirements or through voluntary codes); the organizational structure of the regulatory machinery and whether it ultimately promotes regulation or otherwise facilitates avoidance. It is through the analysis of these issues that the accounting regulation concept seeks to reveal the complex relationship which accounting has with society as a whole.

The concept of accounting regulation, as it is used today in the West, has not enjoyed a comparable measure of attention in Japanese accounting literature. What was employed instead is the concept of *kaikei seido*, literally meaning "accounting institution". This is a key term in developing an appreciation of Japanese research and practice. It implies a view of accounting as a form of social institution. From this perspective, the main thrust of inquiry is focused on the legal framework of accounting regulation, with the primary objective of identifying the economic and ideological functions of that framework.²

The accounting institution concept has been subject to a wide range of interpretations. On the one hand, the concept has been identified with the existing system of laws and other norms. On the other, it has been perceived, on a more abstract, theoretical plane, as an apparatus for promoting exploitation by and accumulation of capital in a capitalist economy and also as an ideological apparatus for vindicating and legitimizing such a process. Some advocates of the concept, out of their zeal to underscore the ideological nature of what they called accounting institution, extended its scope to include both accounting theory and accounting practice, contending that accounting under capitalism would necessarily become an element of the legal, political and ideological superstructure which at once is defined by and in turn underpins the capitalist economy (Miyagami 1959, 1965, 1969, 1979 ; Kanda 1971). From this perspective, accounting in its entirety is conceived as an institution, with the relevant laws and other norms at its core. Accounting practice, as defined by the laws and other norms, is also regarded as part of this institution, along with accounting theory which is perceived as having a legitimizing function (Jinnai 1988).

The accounting institution concept has been instrumental in critically examining the role of accounting in Japanese society. It has made a number of contributions to accounting research. First, it has established the study of accounting as a social science in Japan by

viewing accounting as a social phenomenon occurring in a given social formation. This marks a departure from the conventional focus on interpreting accounting technicalities.

Second, it has highlighted the arbitrary and fictitious aspects of accounting as it exists today, revealing its functions of promoting capital accumulation and of conferring ideological legitimization. Finally, it has facilitated analysis of the accounting institution and accounting policies that underpinned Japan's rapid economic growth (Kakurai 1986, Endo 1986, Oguri 1987). Many of the analyses have focused on the role played by individual financial statement items. For example, studies have examined how accelerated depreciation expedites the expensing of the cost of assets and thus facilitates capital accumulation; how allowances and reserves serve the cause of capital accumulation by retaining profits within the firm and how profits were transformed into expense items through changes in financial statement display in order to understate reported earnings (Kakurai 1973, Endo 1980, Ohashi 1985, Study Group for Critical Financial Analysis 1971, 1972, 1973, Yamaguchi 1977, Nomura 1977).

The recourse to the accounting institution concept in Japanese accounting analyses is attributable, in part, to the fact that Japanese accounting today is governed by the Commercial Code and related statutory rules while private sector regulation of accounting through the accounting profession remains relatively underdeveloped. Thus, in the face of the powerful influence of the state exercised through the force of law, the complex, interactive relationships that surround the capitalist firm tend to be obscured, allowing static concepts such as the one of accounting institution to suffice as the principal frame of reference.

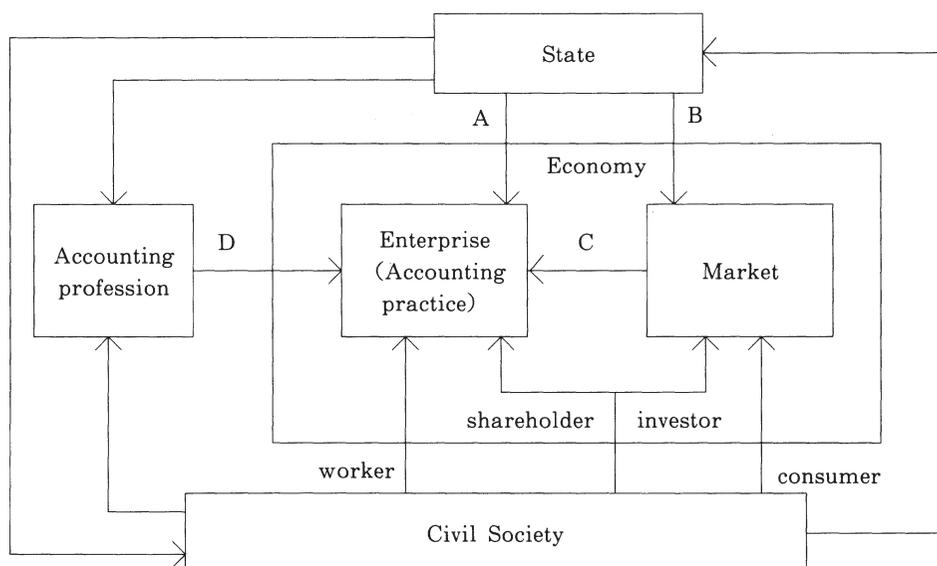
In comparison, the concept of accounting regulation outlined earlier is more functional, more dynamic and more comprehensive. While the accounting institution concept tends to regard the accounting institution as an element of the social superstructure exercising unitary control over accounting matters, the accounting regulation concept facilitates analysis of the interrelationships among the political, economic, social and environmental factors inherent in a social structure and the interplay of regulation and avoidance that develops among organizations or groups with conflicting interests (Taylor & Turley 1986).

The analysis of Japanese regulation presented in this paper draws on both the accounting institution concept and the accounting regulation concept. Before examining the Japanese case, however, a general framework for comparing accounting regulation internationally is proposed in the next section.

2. A GENERAL FRAMEWORK FOR INTERNATIONAL COMPARISON OF ACCOUNTING REGULATION

In discussing the structure of accounting regulation in Japan or any other particular country, it would be necessary to delineate the general relationship among various actors involved in accounting regulation. Identification of such a relationship should also prove useful for comparative studies of accounting regulation across the developed capitalist world. Exhibit 1 represents such an effort, building on earlier comparative studies of differing modes of accounting regulation.

EXHIBIT 1 Regulatory relationships in accounting



The structure shown on Exhibit 1 consists of the state, the economy and the civil society, with the “economy” sphere further divided into the domains of “enterprise” and “market”. The accounting profession is deliberately depicted apart from the three main spheres in order to denote the fact that, while having its origins in the civil society, it has now evolved into a major business undertaking in its own right, empowered by the state to exercise important public functions. The exact position to be occupied by the accounting profession is viewed as being subject to a tug-of-war among the state, the economy and the civil society.

The arrows indicate regulatory relationships. Arrow A represents regulation exercised by the state vis-à-vis the enterprise and its accounting practice. Statutory requirements such as company laws, commercial codes and tax codes are the main components of this type of regulation, the primary objective of which is to balance the often conflicting interests of the various corporate stakeholders (i.e., creditors, shareholders, governments, etc.). In terms of accounting measurement, the primary concern is to determine the amount of distributable income. The state further intervenes to regulate the actual allocation of the distributable corporate income through such official means as economic policy and tax laws and, particularly in the Japanese case, through such less formal means as administrative guidance and personal relationships at executive levels. This type of regulation is often geared to facilitate the accumulation of capital and may at times be better described as serving a guidance, rather than a regulatory, function.

Arrow B represents regulation exercised by the state vis-à-vis the market. For the sake of convenience, the exhibit depicts the enterprise and market as mutually separated

entities. But the market in fact comprehends the enterprise, so that state regulation of the market also serves a form of indirect regulation of the enterprise. The market includes both capital and consumer markets. This category of regulation, achieved through such means as anti-trust, securities and consumer protection laws, is designed to maintain an equitable market and hence an acceptable economic order. Accounting standards play a role in this connection by mandating the disclosure of financial information. Such standards may be imposed on individual enterprises through the authority of the state, but the actual standard-setting process may be left up to accountancy bodies, stock exchanges or academic organizations.

Categories A and B both fall under what is generally termed public regulation but are distinguished from each other because of the differing purposes of regulation. The object of regulation also varies, with category A commonly dealing with companies in general regardless of size and category B concerned with a specific class of companies such as large or listed companies. This distinction is particularly relevant to the consideration of accounting regulation in Japan, where two regulatory regimes, one based on the Commercial Code and the other based on the Securities and Exchange Law, have continued to exist side by side with often conflicting or overlapping mandates.

Arrow C represents regulation exercised by the market itself upon the enterprise. A prime example of this type having an immediate relevance to accounting is regulation by the stock exchange, which requires disclosure of financial information in both primary and secondary markets. In addition, information demands from securities firms and financial analysts are also part of the regulatory effect of the market.

Arrow D represents regulation exercised by the accounting profession upon the enterprise. It relates to both accounting measurement and information disclosure. Audit, which can be thought of as a form of direct regulation of the individual enterprise, is the key instrument for this category of regulation. Underlying the auditing process are auditing standards commonly set by accountancy bodies to complement the kinds of regulation categorized above as A, B and C. The regulatory relationship between the enterprise and the accounting profession, however, is complicated by the growing emphasis on management advisory services which in effect turn the profession into more of a private agent of individual business interests rather than a public vehicle of the attest function. The ways and means of guaranteeing a proper regulatory relationship in this regard remain a widely debated public issue.

Categories C and D are generally termed private regulation, whose regulatory influence is derived from the civil society instead of the authority of the state. Hence, private regulation may be practiced through various actors such as shareholders, investors, workers and consumers through their respective channels of influence, and may manifest itself in a multitude of forms including participation, campaigns, lobbying and other ways of applying pressure.

Based on the accounting regulatory relationships represented by the above model, Exhibits 2, 3 and 4 attempt to highlight the structural characteristics of accounting regulation in Japan, the United States and the European Community, although the simplic-

EXHIBIT 2 Regulatory relationships in Japan

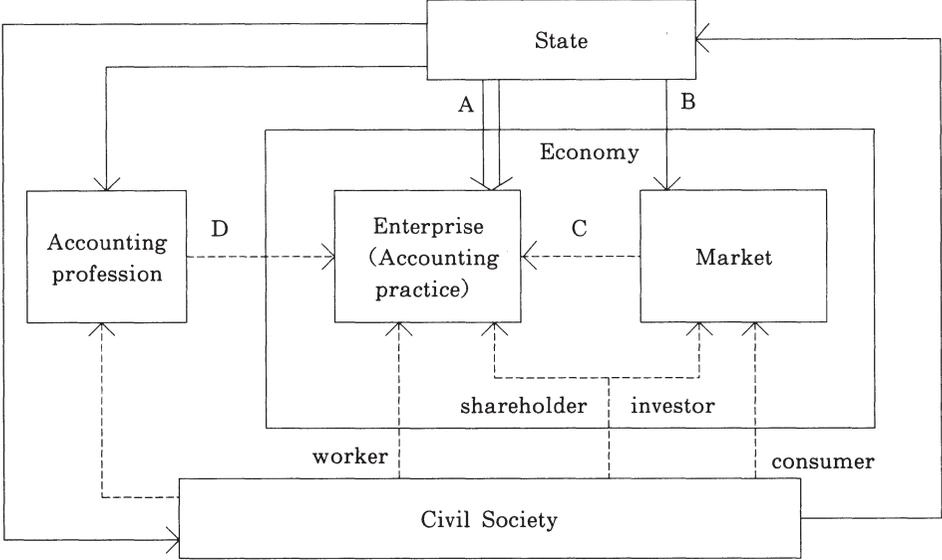


EXHIBIT 3 Regulatory relationships in the United States

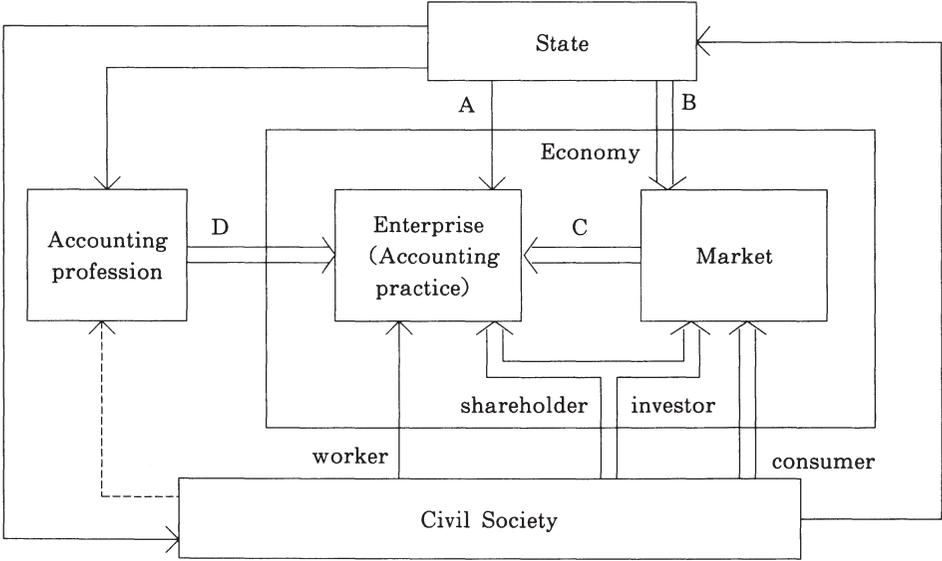
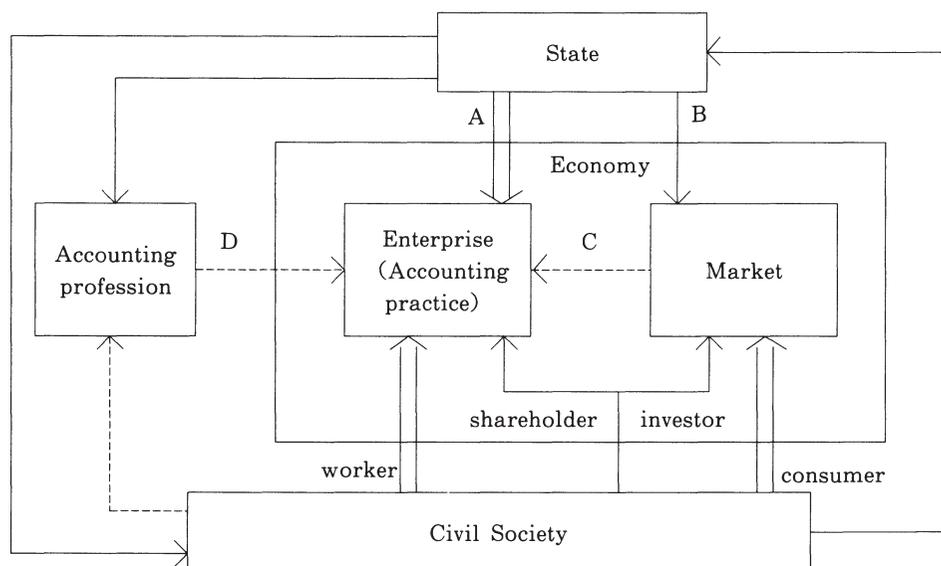


EXHIBIT 4 Regulatory relationships in the European Community



ity of the models obviously precludes precise comparison.

In respect of Exhibit 2, one of the major characteristics of Japanese accounting regulation is the duality of the legal structure, with the Commercial Code and tax laws providing the statutory basis for regulation type A and the Securities and Exchange Law being the basis for regulation type B. Arrow A is depicted in enlarged form to indicate the more commanding regulatory influence it has exerted over corporate accounting practice and the powerful role it has played in promoting capital accumulation. In contrast, importance of regulation type B in maintaining an equitable market order through securities and anti-trust laws has been regarded as secondary in Japan, resulting in a securities market dominated by interlocking corporate shareholdings and subject to insider trading. In Japan, entire markets (or industries), as well as individual enterprises, are subject to administrative guidance by the state bureaucracy, so that basic course of developments in the market rests on a consensus between the state and the enterprise. The pervasiveness and the apparent success with which the visible, guiding hand of the state bureaucracy has been exercised, and willingly accepted by the enterprise sector, has led cynics to observe that Japan might be the one country where socialism prevailed. In the realm of accounting, this state of affairs has translated into a relative lack of emphasis on information disclosure, since the market has been made to function with less than full recourse to accounting information.

Another characteristic of the Japanese case is the weakness of the regulatory influence exerted by the civil society. Individual investors only account for less than 30% of all shares outstanding on the stock market. Individual shareholders are all but written off as

a force in corporate governance. Workers, at least those who enjoy the status of regular employees of major corporations, are largely integrated into the power structure of the enterprise. And the *pro forma* "participation" of some trade unions in corporate decision making is a far cry from anything resembling workers' control. An essential feature of Japanese management stems from a marriage between the "voluntary" and "active" involvement of workers who depend on the enterprise for their livelihood and the ostensibly "benevolent" policy of the enterprise in intergrating the workers on the strength of its economic, social and ideological dominance. As such, one ought to be wary of conferring any unwarranted accolades on post-Fordism. And with the bulk of the accounting profession beholden to the patronage of a few thousand large corporations, private regulation has yet to come into its own as far as Japanese accounting is concerned.

Exhibit 3 represents relationships in U.S. accounting regulation which is characterized by the presence of powerful state (i.e., Federal) regulation of the market (regulation type B) through anti-trust, securities and related laws. Instruments for direct regulation of the enterprise (regulation type A) include company laws of the 50 states of the union as well as Federal and state tax laws, but their relative influence on accounting practice is not quite as dominant as that of the Japanese Commercial and Tax Codes. If the association between the state bureaucracy and corporate interests can be viewed as central to the Japanese regulatory relationship, then the relationship in the U.S. might be described as being built around a more free-wheeling interplay of market forces, which in turn implies active involvement of the civil society. Regulation of and by the market, regulatory pressure by shareholders and investors, and regulatory initiatives by consumers all appear to have a commonality of purpose ; i.e., to maintain an equitable and competitive market order. In addition, private regulation by the accounting profession has played a major role in keeping state intervention at an arm's length. This historical inclination toward private regulation by the accounting profession and against state meddling is obviously traceable th the British accounting tradition. Although not articulated in the exhibit, the Securities and Exchange Commission and the Financial Accounting Standards Board are the entities exercising direct regulatory influence in accounting matters, and, as such, they constitute the essential part of regulation type B. While entrusted by the SEC with standard-setting authority, the FASB has a constituency, including the accounting profession, that represents various sectors of the economy and civil society. Thus in the U.S., accounting regulation is carried out with a powerful private regulation mechanism built into and operating in conjunction with a system of public regulation. In accounting, the emphasis has been on progressively greater disclosure of financial information.

Exhibit 4 is aimed to represent the essential regulatory relationships in member states of the EU. The exhibit draws on relationships evident in the various definitive and proposed EU Council Directives, while mindful of the fact that national differences would clearly defy formulation of any precise, singular model at this stage.

Common features observable in the EU countries include the prominent role of company law in regulating the enterprise (regulation type A) and the relative strength of worker influence through co-determination and other forms of participation. Capital markets in

the EU, with the exception of the United Kingdom, are not as developed as those in the U.S., so that there is a corresponding lack of emphasis on regulating the market. This does not imply, however, that the regulatory influence of the civil society is weak ; on the contrary, European publics are quite actively engaged as workers and as consumers in their relationship with the enterprise and the market.

The cursory comparison noted above was intended as a tentative step toward building a general framework for international comparison of accounting regulation. We shall now move on to a discussion of the structure of accounting regulation in Japan.

3. STRUCTURE OF JAPANESE ACCOUNTING REGULATION

An Examination of the structure of accounting regulation in Japan reveals several important characteristics. One is the primacy of public regulation, or regulation by the state, coupled with the relative underdevelopment of private regulation. Statutory codes combine to form a powerful legal framework and thus the backbone of public regulation of accounting. Although accounting standards in the Anglo-American tradition do play a certain role, they are issued by bodies set up inside the central government bureaucracy and are effectively incorporated into the legal framework.

A second characteristic, pertaining to the geography of organizations involved in accounting regulation, is that a legal framework comprising heterogeneous bodies of law is translated into an array of bureaucratic structures with often conflicting agendas. In addition, those structures provide a mechanism for advancing certain private interests and bringing them to bear upon accounting regulation. And in this connection, a third characteristic is that despite the *pro forma* existence of mandatory public regulation, the actual requirements imposed on accounting practice remain less than stringent in substance and allow room for various forms of avoidance. These characteristics are elaborated below.

(i) Legal Framework and the Primacy of Public Regulation

In the Japanese context, the pre-eminence of public or state regulation is not unique to accounting but rather a pervasive feature of the social fabric of the nation. It is ascribable primarily to the nation's late entry into the global race for capitalist modernization in the nineteenth century and to the leading role played by the state bureaucracy in that drive for modernization. The choice of Bismarckian Germany as the nation's role model prompted the introduction of a German-inspired system of statute law as a mainstay of public regulation. And in contrast to the development of the state bureaucracy, regulation by the private sector remained underdeveloped. Private regulation was expected to flourish as a consequence of post-World War II reforms, but, as will be seen in the following discussion, the results fell substantially short of expectations.

A peculiar trait is readily observable in the legal framework governing Japanese accounting, namely the concomitant existence of the Securities and Exchange Law and the Commercial Code, two bodies of law with different characteristics and purposes. One might

count tax laws as a third component of this multiple legal structure, since they indeed play a special part in Japanese accounting regulation (Choi & Hiramatsu 1987). In this paper, however, the Commercial Code and the tax laws are functionally grouped together and viewed as operating in tandem (see related discussion in the next section). Hence, the legal framework is defined as a dual structure comprising the Securities and Exchange Law and the Commercial Code (plus the tax laws).

The duality of the structure takes on an added significance when we consider the fact that the combination represents a marriage of two heterogeneous legal systems, with the Securities and Exchange Law having its origins in U.S. securities legislation, while the Commercial Code is of Continental European extraction (Morikawa 1986). The two laws each have accounting provisions designed to serve different purposes, and in effect impose a dual form of regulation on the accounting practice of major corporations. This particular form of dual regulation that operates in Japan is quite unique.

The duality in the legal framework evolved after World War II, as the U.S. occupation rule (1945-1952) helped implant the American-inspired Securities and Exchange Law the related system of accounting regulation into a regulatory environment previously governed solely by the German-influenced Commercial Code (Kawai & Terashima 1983). The introduction of the securities legislation had a clear objective. That objective was to democratize the Japanese economy by dismantling the *zaibatsu* : closely-held groups of companies bound together and dominated by holding companies and affiliated banks. The *zaibatsu* were widely regarded as a major driving force behind Japanese militarism. Their dismantling called for the introduction of anti-trust legislation to ban holding companies and for a radical shift in corporate finance away from dependence on bank lending towards direct financing through the securities market. "Democratizing" the corporate structure by dispersing stock holdings and drawing on a vast potential pool of individual investors was considered an effective and essential means of precluding a resurgence of *zaibatsu* control. The Securities and Exchange Law was intended to create such a securities market.

The Securities and Exchange Law of Japan enacted in 1947 (amended in 1948) was modelled on the U.S. securities legislation of 1933 and 1934. It was further augmented by the establishment of a Securities and Exchange Commission, an independent regulatory body also fashioned after the U.S. precedent. The Commission's role was to regulate both the activities of the newly established stock exchanges, and public financial disclosure by corporations trading on the exchanges.

In 1949, the Japanese Institute of Certified Public Accountants (JICPA) was established. Shortly thereafter, the *Financial Accounting Standards for Business Enterprises* were issued.³ The stage was thus set for accounting regulation under the U.S.- influenced Securities and Exchange Law, featuring emphasis on private regulation, generally accepted accounting principles and disclosure of accounting information (Tsumori 1988). The subsequent history of Japanese accounting regulation, however, was to be characterized by both conflict and compromise between the two disparate legal systems of the Commercial Code and the Securities and Exchange Law.

A primary difference between the Securities and Exchange Law and the Commercial

Code lies in their scope of application. The Securities and Exchange law applies only to some 3,000 joint stock companies whose shares are listed on the nation's stock exchanges or traded over the counter. The Commercial Code applies to all forms of business organization and features accounting provisions that apply to all joint stock companies, the most popular form of business organization in Japan numbering upwards of one million.

A second difference lies in the intended aims of the two laws. The Securities and Exchange Law is designed primarily to protect present and future investors in the securities market, while the Commercial Code is intended mainly to protect creditors and present shareholders in the process of sorting out conflicting claims on joint stock companies (Morikawa 1986).

The different aims of the two laws give rise to a difference in the type of information that accounting is expected to measure and disclose. The Securities and Exchange Law emphasizes disclosure of accounting information needed for equity transaction, notably earnings information as indicators of corporate performance, while the Commercial Code calls for accounting measurement to be geared to capital maintenance and determination of distributable income.

A fourth difference is that while the Commercial Code relies primarily on its own mandatory provisions for enforcement, the Securities and Exchange Law is predicated on the performance of external audit by independent CPAs. CPA audit was the primary vehicle for the private regulation of accounting embedded in the Securities and Exchange Law under the influence of the occupation rule. In summary, the difference between the two legal systems involves, to a certain extent, the choice of public versus private regulation.

In the conflict between the two legal systems since the early post-war years, the initial primacy of accounting regulation based on the Securities and Exchange Law has given way to the regime based on the Commercial Code. The Securities and Exchange Commission, the independent body established to administer the Securities and Exchange Law, was abolished in 1952, shortly after the end of the occupation. The functions of the Commission were transferred to the Securities Bureau of the Ministry of Finance. However, only a fraction of the initial mandate of the Commission survived. This change represented a retreat, of sorts, of a foreign or extraneous system (i.e. the U.S.- inspired Securities and Exchange Law regime) in the face of a more entrenched or indigenous form of public regulation administered by a government bureaucracy intimately linked with the business community.

A second element of private regulation embedded in the Securities and Exchange Law was the *Financial Accounting Standards for Business Enterprises* issued in 1949 by the Investigation Committee on Business Accounting Systems. The Investigation Committee was the predecessor of the present-day Business Accounting Deliberation Council (BADC).⁴ The publication of the standards came in response to *Instructions on the Preparation of Financial Statements by Industrial and Commercial Concerns* issued by the U.S. occupation authorities for dissolving the *zaibatsu* and democratizing the economy (Kawai & Terashima 1983). Drawing on and characterized as resembling the generally accepted

accounting principles in the U.S., the standards were designed to modernize Japanese corporate accounting. The preamble to the standards defined their nature and role as : (a) a summary of accounting conventions which have been generally accepted as fair and proper [and which] should be followed by all business enterprises, even if it has no statutory binding force ; (b) the standards that Certified Public Accountants should follow when they audit financial statements under the requirements of the Certified Public Accountant Law and Securities and Exchange Law in Japan ; and (c) the standards that should be highly regarded when the laws and ordinances affecting business accounting, such as the Commercial Code or the tax law, are enacted, amended, or abolished in the future.

The initial post-war design, then, was to create a system of accounting regulation around the standards, with accounting practice on individual issues to be regulated not by law but by accounting standards issued by a standard-setting body favoring a private regulation approach. In fact, however, conditions were less than favorable for such accounting principles or standards to evolve from accounting practice in a country with scant tradition of private autonomy. Whereas the generally accepted accounting principles in the American tradition were envisaged to result from broad recognition of accounting conventions and the distillation of accepted practices, the Japanese experience saw the imposition of what was apparently a seminal core of generally accepted accounting principles. This process was carried out through a governmental body under U.S. occupation.

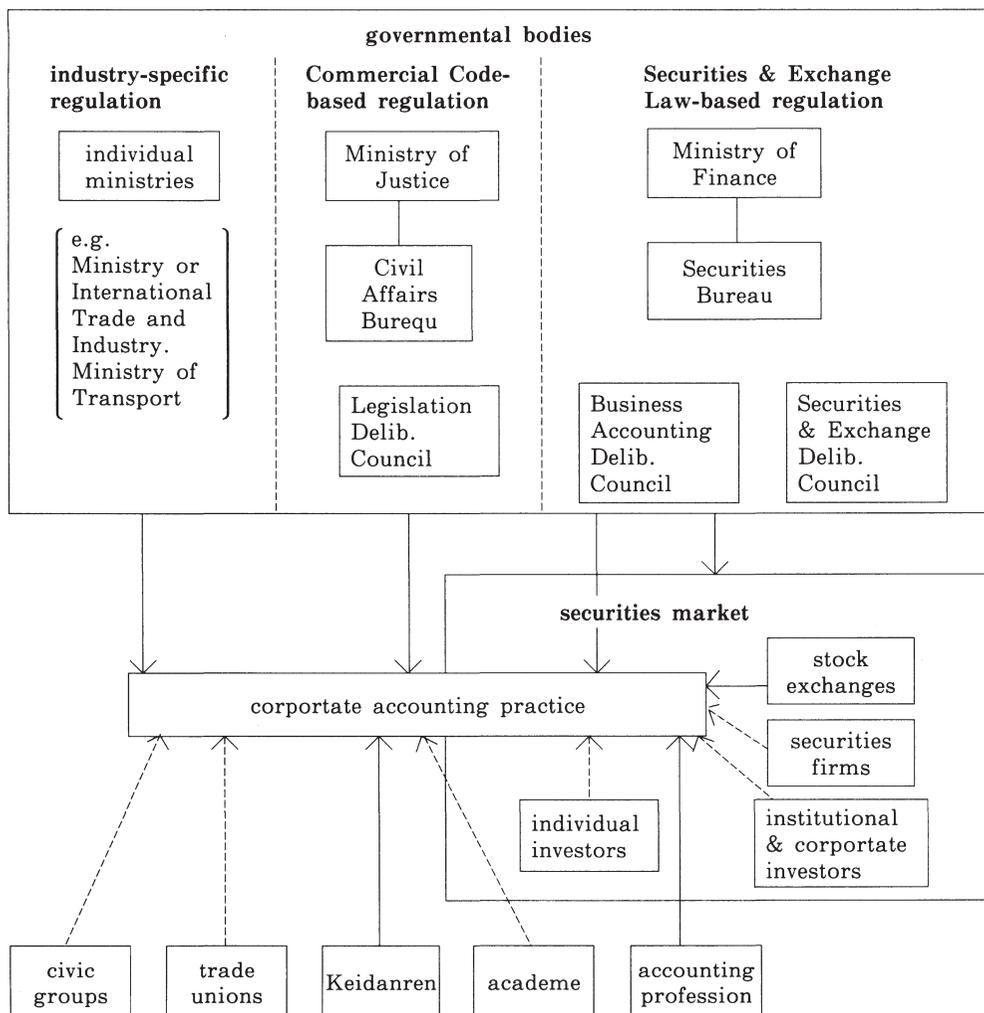
Within the Securities and Exchange Law regime, the standards fulfilled a special role. When the law was revised in 1950, the accounting standards were fleshed and issued as a Ministry of Finance Ordinance, entitled *Regulations Concerning the Terminology, Forms and Preparation Methods of Financial Statements*. Contrary to the private sector standard-setting approach taken in the United States, the standard-setting body in Japan, the BADC, has remained in the public sector as part of the Finance Ministry.

After being embodied in the legal framework as principles for the modernization of accounting in Japan, the accounting standards, as originally conceived, have progressively lost influence. Certain parts of their contents have been introduced into the Commercial Code with the original standards being subject to successive amendments in a compromise with the Commercial Code. The declining influence of the standards has paralleled the shift in primacy from the Securities and Exchange Law-oriented regime of accounting regulation to one based on the Commercial Code. In 1962, the Commercial Code was revised to incorporate elements of accounting regulation originally contained in the Securities and Exchange Law-based regime, inaugurating a fully fledged system of accounting regulation based on the Commercial Code. The contradictions between the two legal systems were thus tentatively put to rest in favor of a Commercial Code-based system.

(ii) Geography of Accounting Regulation and Regulation in Practice.

The geography of organizations involved in Japanese accounting regulation also reveals characteristic features of the Japanese scene. Exhibit 5 depicts the structure of accounting regulation in Japan.

EXHIBIT 5 Geography of Accounting Regulation in Japan



The organizational machinery for accounting regulation remains unintegrated, with related functions scattered across a number of governmental bodies, resulting at times in a confusing state of affairs. Regulatory authority over the securities market on the basis of the Securities and Exchange Law is vested in the Securities Bureau of the Finance Ministry. Two advisory bodies to the Finance Minister, the Securities and Exchange Deliberation Council and the BADC, are involved, respectively, in revising the Securities and Exchange Law and setting accounting standards. Overall regulation of the legal aspects of business activity is the domain of the Civil Affairs Bureau of the Ministry of Justice. An advisory body to the Justice Minister, the Legislation Deliberation Council, has a committee charged with discussing amendments to the Commercial Code.

Under the dual regulatory framework, these two ministries and their advisory organs

have pursued their own respective agendas, often resulting in unreconciled, if not openly contradictory, positions. Another impediment to an integrated regulatory machinery is that the accounting standard-setting for specific industries is placed under the auspices of the related ministries or agencies instead of the BADC. Hence, the BADC's potential function as a standard-setting body is undercut and parceled out to a number of other governmental bodies without effective coordination.

Some extra comment may be in order at this juncture on the special role played by deliberative bodies such as the BADC in Japanese politics and public administration. For most of the four and a half decades since the end of World War II, power has resided with a strategic triad formed by the perennially ruling (and conservative) Liberal Democratic Party, the bureaucracy and the business community (Masujima 1974). Deliberative bodies serve a "useful" purpose in this context by reconciling different interests and forging at least a semblance of consensus. Comprising representatives of the business community, other interested parties (at times including trade unions), academe and the relevant professions, these advisory bodies participate, or at least go through the motions of participating, in the formulation of public policy and legislation on request from the related ministries. Positioned at the interface of public and private regulation, such deliberative bodies in effect play a significant part in legitimizing the policy-making or standard-setting process and inducing the public to consent to the existing order.

Among the various agents of private regulation in Japanese accounting, the two noteworthy ones are the Japanese Institute of Certified Public Accountants representing the accounting profession, and the Japan Federation of Economic Organizations, the main big business body known by its Japanese acronym of *Keidanren*.

The accounting profession is technically the primary agent of private regulation, responsible for verifying compliance with the accounting regulatory process under the Securities and Exchange Law through its audit function. In the Anglo-American context, the profession has historically assumed the role of standard-setting, alone or in conjunction with other parties. But in Japan, where the system of CPAs is a post-war novelty and where private autonomy is hardly conventional practice, the accounting profession has yet to come into its own. The JICPA does not wield much authority and its influence over accounting regulation and accounting standard-setting is limited at best.

Keidanren, on the other hand, exercises a formidable influence over accounting regulation as well as many other aspects of the political and socio-economic life of the nation. Widely recognized as playing the leading role among Japan's four major business organizations, *Keidanren* has continually brought its influence to bear on the accounting regulation process. It has consistently lobbied for deregulation both officially through its representatives sitting on every major deliberative body and unofficially through its cozy relationship with the ruling conservative party and the bureaucracy. And internationally, it should be noted, *Keidanren* has lobbied with a vengeance against what it perceived as intrusive accounting and disclosure requirements of the U.S. Securities and Exchange Commission and the European Community. The latter case involves the still pending Vredeling proposals for employee consultation and information disclosure in multinational firms.⁵

With regard to domestic accounting regulation, *Keidanren* publishes its “model format” for financial statements devoted to satisfying no more than the minimal disclosure requirements and thus serves to loosen accounting regulation in its application. That such a model format is published alongside official accounting standards and statutory rules in annual handbooks of accounting rules and, in effect, serves a normative function, provides a telling commentary on the nature of present-day accounting regulation in Japan.

That the big business lobby is allowed such measure of influence in Japan is predicated on the traditional partnership or cooperative interaction between government and business, which explains the apparent discrepancy between the ostensibly rigid regulation of accounting by the state and the actual tendency to allow business to exercise a wide margin of discretion in accounting matters. It was this problematical aspect of Japanese life that instigated the earlier-mentioned critique by the accounting institution school that the legal regulatory framework as a whole performed both a capital accumulation function and an ideological legitimization function (Oguri 1988, Endo 1983.)

4. FACTORS BEHIND THE JAPANESE REGIME OF ACCOUNTING REGULATION

The transition in primacy from accounting regulation based on the Securities and Exchange Law to one based on the Commercial Code can be attributed to at least two major factors. The first is the laggard development of the securities market, contrary to the initial design of the post-war reformers to render it the primary source of corporate finance. The second factor is the compelling influence of tax laws. Both of these factors figured prominently in shaping the contours of Japanese accounting regulation today.

Concerning the first factor, bank lending provided the primary source of corporate finance during the years of Japan’s phenomenal post-war growth, stretching from the mid-1950s through the end of the 1960s (Miyazaki 1985). The securities market did expand quite rapidly at the outset, but subsequently took a back seat to bank lending, becoming resigned to a marginal, complementary role. This kind of financing arrangement accordingly called for a type of accounting regulation oriented towards protection of banks and other creditors, i.e. regulation based on the Commercial Code, rather than one with a securities market orientation. Although the securities market, notably the Tokyo Stock Exchange, has since grown in size and in fact swelled in the 1980s to have the largest market capitalization in the world, it remains fraught with serious distortions. Major corporations and banks have formed *Keiretsu* groupings, with mutual shareholdings cementing the relationship among member companies (Okumura 1984). This, in turn, has channeled an increasing proportion of outstanding shares into the hands of corporate and institutional investors, consequently marginalizing the presence of individual investors who now account for less than 30% of all shares outstanding. This, along with the oligopolistic hold on the equity market by the nation’s four major securities houses, has impeded a more normal and competitive growth and functioning of the Japanese capital market (*Kinyu Business*, November 1994).

One consequence of this anomaly has been the extremely low payout ratio. Rayout ratios

for the period April 1992 to March 1993 averaged 29 per cent for Japanese companies compared with average ratios of 53 per cent in the United States, 54 per cent in the United Kingdom, 50 per cent in what was then West Germany and 38 per cent in France. Hence, major Japanese firms retain a high percentage of their income instead of distributing it as dividends to shareholders. The firms have been relatively unconstrained in their pursuit of capital accumulation without much of the shareholder pressure for greater short-term payoffs.

The above features have meant that a Securities and Exchange Law based on an assumption of normally functioning securities markets and designed to induce firms to disclose relevant accounting information, has found the Japanese securities markets inhospitable terrain. Considering the odds against the Securities and Exchange Law-based system of accounting regulation, it was quite logical for the Commercial Code-based system to move in to fill the regulatory void.

The second important factor promoting the primacy of the Commercial Code-based regulation is the fact that a regulatory regime centering on the Commercial Code was viewed as essential from the standpoint of taxation policy and its administrators within the Finance Ministry. It will be recalled that the Ministry of Finance also administers the Securities and Exchange Law. As a crucial vehicle of the government's economic policy for facilitating capital accumulation, Japanese tax laws have lavished on major corporations opportunities for minimizing their tax burden, starting with the Special Taxation Measures Law enacted in the 1950s. Meanwhile, the Corporate Income Tax Law required that tax returns be computed on the basis of financial statements prepared in accordance with the Commercial Code. Hence, legitimization of the preferential measures provided by the tax laws required first that corresponding provisions be written into the Commercial Code; and second that such a Commercial Code supplant the Securities and Exchange Law-based regime as the main source of Japanese accounting regulation.

It was no accident, then, that on the occasion of the landmark 1962 revision of the Commercial Code signalling its newly found ascendancy over the Securities and Exchange Law, the Code adopted, among other things, a dubious category of allowances called *tokutei hikiatekin*, literally "specified allowances", which represented a transposition of tax law-approved allowances specifically designed to conceal reported profits and hence accumulate capital. As a result of this measure, as many as 16 different types of tax-exempt allowances and provisions found their way into corporate financial statements along with an additional set of taxable, discretionary provisions ("provision for construction of research laboratories" and "provision for events marking the corporate semi-centennial", for example), all of which served to accelerate the process of retaining profits within the firm (Kakurai 1973, Endo 1980).

Thus, the dependence on bank lending in corporate finance and the orientation of tax laws geared to capital accumulation, two important factors that enabled Japanese business expansion and economic growth, concurrently served to nudge accounting regulation away from the Securities and Exchange Law towards the Commercial Code. The centrality of the Commercial Code and the attendant formula of regulation by the state apparently

proved to be a more “natural” regulatory arrangement in view of the aforementioned affinity between business on the one hand and political and bureaucratic leadership on the other.

In retrospect, that has more or less been the way of life for Japanese capitalism ever since its late-19th century inception, when the fledgling central government made it its prime business to initiate, nurture and protect a nascent business community. In formulating its economic policy, the government was concerned first and foremost with ways to allow businesses to grow. Hence, the natural inclination in official policy was to provide protection and preferential treatment for the champions of Japanese business. When applied to the realm of accounting, this general rule would logically call for a type of regulation which, though couched in statutory terms, allows the choice of conservative accounting methods and serves as an instrument of the national policy of capital accumulation. Accordingly, accounting rules which in effect facilitate avoidance of regulation are internalized in the legal regulatory framework.

5. PROSPECTS

The dual legal structure of Japanese accounting regulation presided over by the Commercial Code is now faced with the need to accommodate itself to the move toward international harmonization of accounting and reporting standards, in which the dominant influence can be identified as an approach of extensive disclosure for the benefit of the securities market.

In 1977, preparation and disclosure of consolidated and interim financial statements were institutionalized within the Securities and Exchange Law-based regulatory framework. Since the 1980s, other incremental changes to reinforce that framework have been under consideration, including introduction of segmental reporting, issuance of official opinions on accounting for futures and options transactions and a wholesale review of auditing standards. The most recent developments include the establishment of a Corporate Finance System Research Institute (COFRI), which is a deliberative body modelled on the American FASB, and the enactment of disclosure rules concerning gains and losses on securities portfolios and also concerning stock holdings of five per cent or more in a given company, often a *Keiretsu* affiliate. These steps towards greater disclosure have been spurred by foreign influence accompanying the stepped-up internationalization of Japan's economic and business activity and hence of its accounting practice. Notable catalysts forcing the pace of change include political pressure from the United States, particularly via the bilateral Structural Impediments Initiative talks, rising momentum on the part of the International Organization of Securities Commissioners (IOSCO) towards concerted regulation of the world's major securities markets, and the willingness of the International Accounting Standards Committee to take further steps towards international harmonization.

Even the Commercial Code was revised in 1981 to accommodate more extensive disclosure requirements — a clear commentary on the inadequacy of the uniquely Japanese

system of accounting regulation described above in meeting the challenges of internationalization. It is important to remember, however, that demands for such extensions in corporate disclosure were essentially of foreign origin, not an indigenous product of the Japanese securities markets. Pressure from forces outside the financial community, such as trade unions and civic groups, does exist but is hardly adequate to force changes in the legal framework. So despite the *pro forma* extension of disclosure requirements to keep Japan in line with international trends, doubts persist whether the regulatory authorities are willing and/or able to actually give effect to the requirements, when the Finance Ministry's Securities Bureau has to operate on a skeleton staff of 130 compared with a legion of 2,000 at the U.S. Securities and Exchange Commission.

The problems in Japanese accounting regulation cited above are a reflection of the systemic characteristics of the political and socio-economic life of the nation. More elaborate inquiries of accounting regulation and international comparisons are needed to outline possible directions for regulatory reform. In this connection, there is a need to examine certain parallels existing between the regulatory systems and environments in Japan and the EC countries, especially those of Continental Europe.

The author believes that a certain combination of public and private regulation is necessary and desirable. Neither exclusive regulation by an all-powerful state nor exclusive dependence on private sector self-regulation through the market mechanism and private contractual relationships among business entities is likely to provide an adequate solution. Under any regime of accounting regulation, the presence of a working mechanism of accountability would seem to represent a crucial factor. In order to establish accountability vis-a-vis the society at large, there must on the one hand be a civil society observing an equitable relationship of rights and obligations for all, while on the other hand the society must devise some kind of regulatory mechanism to harness and guide accounting behavior.

FOOTNOTES

1. A clear definition of the concept of accounting regulation is not available. Parker and Previts (Previts, 1987 p. 1) note that : "Regulation is a powerful and complex social device which is difficult to comprehend." Although a range of view exists on the concept of accounting regulation, the present paper draws primarily on the work of as Tinker (1984, 1985), Taylor and Turley (1986), Merino and Neimark (1982) and Puxty *et al.* (1987).
2. Kazuo Miyagami is generally credited with having established the accounting institution concept and imparting a major theoretical influence (Miyagami 1952, 1959, 1965, 1969, 1979). Diverse tendencies subsequently emerged in the process of the concept's evolution and contributed to a lively debate (cf. Endo 1986, Oguri 1987, 1988). Major participants to the debate include : Asaba 1975 ; Endo 1980 ; Kakurai 1973, 1978 ; Kanda 1971 ; Tsumori 1972, 1973, 1982 ; Nishimura 1977 and Shikita 1969. In addition, Nakamura 1969 and Takatera & Daigo 1979 are among those who have identified accounting policy as representing the dynamic aspects of the accounting institution and analyzed the economic and ideological functions of accounting policies.
3. The Financial Accounting Standards were initially referred to as *A Statement of Business Accounting Principles*, and were based on *A Statement of Accounting Principles*, prepared for the American Institute of Certified Public Accountants by Sanders *et al.* (1938).
4. As of July 1986, the Business Accounting Deliberation Council had 39 members. Thirteen were

selected from academia (9 from accounting, 3 from law and 1 from tax), 9 from the business community (3 from the Federation of Economic Organization or *Keidanren*, 2 from banks and 4 from non-banking corporation), 6 from the Japanese Institute of Certified Public Accountants (JICPA), 3 from the Tokyo Stock Exchange, 2 from the Securities Analysts' Association, 2 from economic journalists, and the remaining were from the Ministry of Justice, the Securities Dealers Association, the Japan Federation of Tax Accountants Associations or *Nippon Zeirishikai Rengokai* and the National Association of Small and Medium Enterprises (Choi & Hiramatsu 1987).

5. Kuwabara (1983) provides an account of *Keidanren's* lobbying efforts vis-à-vis the Securities and Exchange Commission. Regarding *Keidanren's* intervention to neutralize the European Community's Vredeling proposals, *Keidanren*, "Vredeling Hoan ni kannsuru Iken" ("Opinion on the 'Vredeling proposals'") *Keidanren Geppo*, September 1982, outlines the business group's official position, while Tsugio Ibayashi, "Vredeling Hoan ni tuite" ("On the Vredeling proposals"), *Kigyō Kaikai*, Vol. 36, No. 2, February 1984, represents a commentary on the issue by a ranking *Keidanren* official. Another article by a *Keidanren* official, Yoshimasa Kubouchi, "Kokuren ni okeru Hi-kaikei Joho no Shingi Jokyo ni tuite" ("On the state of UN deliberations concerning non-accounting information"), *Keidanren Geppo*, June 1981, explains *Keidanren's* policy towards the discussions taking place under the auspices of the United Nations working group on international standards of accounting and reporting for transnational corporations.

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