A Japanese Perspective on the Relationship between Capital Ownership Relations and the Function of Corporate Accounting*

Hideharu Okuda
Yoshiaki Jinnai

Abstract

This paper considers the relationship between capital ownership relations and the function of corporate accounting in Japan. It is often said that Japanese capitalism, through the mutual shareholdings between/among Keiretsu (group) companies since 1950s to 1990s, had succeeded in placing the shareholders as natural persons out of the controlling shareholders of each group company, and in making these companies as legal persons the substantial subjects of each company. K. Iwai (1997, p. 100) regards Japanese capitalism as the "pure" mode of capitalism.

This paper traces the historical development of Japanese stock corporations and identifies three types of capital ownership relations: Type 1 is the original form of stock corporation in which the business entity simply bears the form of legal person; the shareholders are substantial owners and entrepreneurs of the corporation. In Type 1, the stress in corporate accounting is upon accurate calculation of annual profit, and accrual accounting based on historical cost principle served to this function.

Type 2 is that which corresponds to Japanese typical Keiretsu (group) ownership of capital; mutual shareholding, which was formed in 1950s and developed up to 1990s. In Type 2, the management has comparative autonomy in their decisions in investment from a long-term perspective for further development and capital accumulation of the corporation. The major function of corporate accounting for Type 2 is calculating the recovery of invested capital, and cash flow statement based on the historical cost principle is suitable to this function.

Type 3 corresponds to the capital ownership by securities investors in stock market. In this type, the corporations are compelled to pay much attention to the investors, and stress in corporate accounting comes to be on providing accounting information about the economic value of the corporation, which can be used by security investors' anticipation of future market prices of the corporation, and thus the balance sheet based on fair value, rather than profit and loss statement based on past transactions, becomes in the center of corporate accounting.

The paper analyses the recent changes in capital ownership relations of large Japanese companies, and locates the recent changes in Japanese accounting standards in the transformation of the capital ownership relations.

KEYWORDS

Accounting Big Bang; globalization of accounting; Japanese accounting standards; nature of corporation; capital ownership relations; Keiretsu; mutual holding; corporate accounting

Introduction

Through the "Accounting Big Bang" (the Big Bang) having lasted for a decade from the end of the last century, Japanese accounting standards have been drastically changed. Most of those changes are convergence around accounting principles generally accepted in the U. S. (U. S. GAAP) in the first stage of the Big Bang and then, International Financial Reporting Standards (IFRS). The Enron debacle was one of the reasons that the principle-based IFRS became more attractive for investors than the rule-based U. S. GAAP. Before the Big Bang, corporate accounting in Japan was sustained by the "triangle" relationship of three accounting laws and regulations: Commercial Code, Tax Law, and Securities Exchange Law. This relation of three laws and regulations is called the "Triangle System," which explains one of the characteristics of Japanese Accounting system (Matsumoto, 2014, p. 13). The accounting theory that underlies the Triangle System depends on the Corporate Accounting Principles issued by the Business Accounting Council of the Ministry of Finance in 1949. The Corporate Accounting Principles advocates for historical cost principles (historical cost and realized revenue) model. The Big Bang replaced historical cost principle that had sustained the triangle relationship, by fair value principle.

There are three factors accelerating the convergence with the global standards in Japan. Firstly, during the bubble-bursting years of 1991–2002, many Japanese banks and securities companies hid unrealized losses of securities, non-performing loans and other financial instruments by measuring based on their historical costs, which was blamed as one of the main reasons for the eventual collapses of Yamaichi Securities Company Ltd., Sanyo Securities Company Ltd., Long Term Credit Bank of Japan, and other financial institutions.

Secondly, importance and acceptability of international standards were promoted along with the increase in the number of multinational corporations and the growth of global stock markets. Global businesses benefit from the convergence for their preparing financial reporting if accounting rules among their group companies are harmonized worldwide. Equity and debt providers on global stock markets need to have accounting information that they can understand when making investment decisions. Therefore, from the viewpoint of cost reduction, international standards can benefit for corporate managers, creditors, preparers, analysts and the general public (Conover & Niswander, 2011, pp. 1–5).

Third and most fundamentally, the capital ownership relation has changed. While the mutual shareholdings between/among Keiretsu (group) companies have been loosened, the shares of global investors and institutional investors like fund trusts have increased and their presence and voices began to affect the financial reporting of investees. The stocks change hands more globally and explicitly by those investors, who use accounting information to appraise the fair market value of investee corporations.

Globalization of Japanese accounting standards

It is generally said that accounting has three functions: (1) provision of information for business administration, (2) calculation of distributable income, and (3) provision of corporate financial information to securities market (Matsumoto, 2014, pp. 11–12). The Triangle System in Japan worked under the relationship of three laws and the accounting functions. That is, the Commercial Code stresses importance on the discharge of stewardship accountability of management, and (2), the Securities and Exchange Law on (1) and (3), and the Corporate Income Tax on (2) (Arai & Shiratori, 1991)

However, for a decade from the end of last century, Japanese accounting standards were revised one after another, resulting to an almost completely new set of standards. Exhibit 1 shows their schedule, which listed corporations had to follow.

Revised Standards for (a) Consolidated Financial Reporting, (b) Financial Instruments, (c) Pensions, and (d) Income Tax were those that had far-reaching influences on the accounting practices. For example, a corporation (NYK Line 1999–2002) listed in Tokyo Stock Exchange changed its accounting policies as follows.

(a) From the accounting year ended at 31 March 2000 (year 1999), its consolidated

Exhibit 1

Accounting year starting from 1 April	Topics for that Accounting Standards newly settled or revised	Other laws and regulations affecting financial reporting
1999	Deferred Income Taxes Cnsolidated Financial Statements Cash Flow Statement	
2000	Financial Instruments (part) Pensions Foreign Exchange Real Estate for Sale	
2001	Financial Instruments	
2002	Auditing Standards	revised Commercial Code
2003	Directors Remuneration	
2004	Impairment of Assets	
2005		Management Confirmation Letter (Tokyo Stock Exchange)
2006	Intangible Assets	new Corporation Law new Financial Instruments and Exchange Act
2007	Ddeprecialtion of PPE(responring to revised Tax Law)	preparation fo implementing of regulations for Internal Controle Reporting from next year
2008	Inventories Leasees Interim Financial Reporting	Internal Control Report (called JSOX: Japanese Sarbanes-Oxley Act)
2009	Financial Instruments (revised)	
2010	Asset Retirement Obligations Segment Information Comprehensive Income	
2011	Accounting Changes & Correction of Errors	

financial statements appear first as a principal means for financial reporting followed by its non-consolidated statements of its parent company as supporting statements, which had previously played principal roles.

(b) In year 2000, account receivables were classified into general claims, claims with default possibility, and claims in bankruptcy and reorganization. The expected losses arising from such receivables were estimated individually and posted as allowance for uncollectible accounts, which amounts had been based on the deductibles defined in corporate income tax law. Investment securities were classified into trading, held-to-maturity, and others. From year 2000, trading securities were measured by market prices, and held-to-maturity securities by amortized costs, while other securities were measured by market prices or fair value, which unrealized profit or loss were posted directly into shareholders equity section starting from year 2001. Derivatives were also recognized and measured by fair value from year 2000. Previously, listed securities were measured by low-or-cost with moving average method, and unlisted securities were by historical costs with moving average costs.

(c) From year 2000, pension liabilities and costs were calculated based on PBO, while previously contribution to pension plans as external reserve and the allowance as internal reserve had been expensed up to a certain percent (usually 40% that the tax law allowed deductible) of the amount which would be required if all employees terminated their employment voluntarily as of the balance sheet date.

(d) From year 1999, deferred income tax liability or asset is recognized on the estimated future tax effects attributable to temporary differences and carry-forwards, in addition to a current tax liability or asset recognized for the estimated taxes payable of refundable on tax returns for the current year.

The underlying concepts for these changes are fair vale principle, investor oriented, and corporate governance.

Capital ownership relations of corporation

Nature of corporation

A corporation is defined as an entity having authority under law to act as a single person distinct from the shareholders who own it and having right to issue stock and exist indefinitely (Garner, 2014). In other words, a corporation is an artificial being created by operation of law (Hardwicke, J., and Emerson, R., 1992). Corporate attributes are a legal person, creation by law, limited liability of shareholders, and perpetual existence. A corporation is a person, who can sue and be sued, make contracts, own property, and perform other personal acts, separated from its stockholders, directors, officers, and employees. A corporation is a thing, which is owned by its stockholders through their ownership of its stocks. A person cannot be owned by another person except a slave. Thus Iwai (1997) argues that corporation has dual nature: a person and a thing, which is shown in

Figure 1

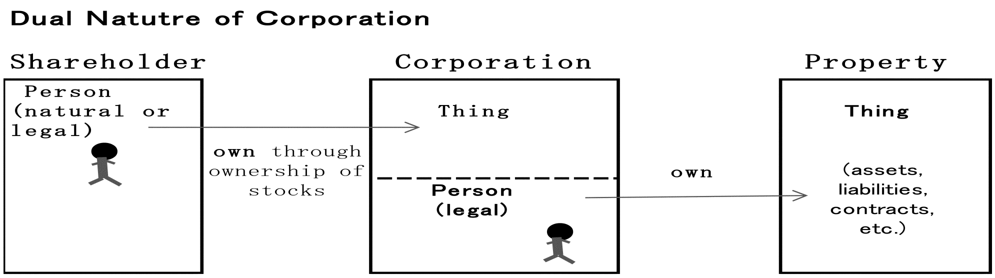

Figure 1.

Three types of capital ownership relations

This dual nature of corporation leads to three types of corporation based on capital ownership relations: person, thing, and the unity of person and thing. Type 1 represents the unity of person and thing. This type is the original form of corporation, where their shareholders participate and play key roles in the corporate business as owner-operators, members of management, directors, and other significant constituents of the business. A corporation is the incorporated entity. Littleton (1933, pp. 242-244) argued that three factors of the church, the craft union, and the town in the Middle Ages are recognized for the appearance and acceptance of entity, characteristics of which are a sense of "corporateness," "one-ness," and separately held private property. Thus, in substance, a corporation as a incorporate entity, has "corporateness" and "one-ness" of its constituent members. In type 1, shareholders claim their shares in the annual profit that is earned from running business by all constituent members.

Type 2 represents a corporation as a person. With silent shareholders, a corporation is managed from the standpoint of capital accumulation. Iwai (1997, p. 76) provides a theoretical example. If a group of corporations consists of 21 member corporations and every member corporation owns 5% shares of all other 20 member corporations, no single corporation is substantially owned by any shareholder. Though it is a mere theoretical ownership relation, its similar relation was realized in Japan during its high economic growth period through Keiretsu mutual holdings. Under Keiretsu mutual holdings, the only side of nature of corporation as a person was actualized. Thus, with their silent shareholders, Keiretsu mutual shareholdings enabled the corporations to pursue the efficiency and effectiveness of capital. Iwai calls these situations "pure" mode of capitalism. Jinnai (1990, p. 16) indicates that under mutual share holdings, two major consequences are found in the behavior of corporate managers. Firstly, they tend not to pay much attention to "outer" affairs such as the increase in the market price of the company's share, the increase in the amount of dividends per share, and the communication with shareholders by use of annual reports. Secondly, they can concentrate on "inner" management affairs such as the increase in market share of major products, the improvement of productivity of their production lines, and the development of new products.

In type 3, a corporation as a thing, shareholders appear as investors in stock market. Investors trade the stocks of corporations when stock prices, they think, move apart from their fair value or intrinsic value high or low enough to realize capital gains. Stock change hands of securities investors, who are not the constituents of the corporate business but regard a corporation as a thing to be invested for capital gains.

Change of capital ownership relations in Japan

Before the World War II, business corporations in Japan were generally heteronomous. Ono (2008, pp. 145–148) classifies those corporations into three categories: owner-operator, professional manager, and Zaibatsu corporations. Owner-operators, usually also serving as directors, claimed dividends and director remuneration as much as possible. Professional managers also allowed high dividends to shareholders on their requirement, while Zaibatsu corporations kept dividends small to enable to reinvest most profit from a long term perspective. Therefore, in the first half of the 20th century in Japan, type 1 was the dominant type of capital ownership for business corporations.

Exhibit 2 (Nitta, 2009, p. 11) is the table for the change of shares of various types of shareholders in Japan for 21years for 1987–2008.

Exhibit 2 shows three points for the change of shareholdings structure. Firstly, during year 1987–1997, the last decade of high growth of Japanese economy, mutual holdings recorded high of 14–15%, and dropped to 8–9% thereafter. Mutual shareholdings that were dominant during the period of high growth of Japanese economy represent Type 2 of capital ownership.

Secondly, institutional investors increased three-four times from 5–7% to 18–21%. That is, mutual holdings have been loosened, while the shares of institutional investors have increased. It means that after the beginning of the 21st century, institutional investors, domestic or abroad, became to occupy the largest portion of capital ownership relations.

Thirdly, shareholders with close relationship with corporations increased from 6–7% to 11%. They are the constituent members of the corporation and hold shares from a long term perspective. Their increase may compensate for the decrease of mutual holdings and are expected as stable shareholders against the increased voices of securities investors in stock market.

Types of corporations and functions of corporate accounting

Types of corporations can be also associated with three functions of accounting mentioned previously. That is, type 1 corresponds to function (2) of calculating distributable

Exhibit 2

Shareholdings of listed companies (Security Exchange of Tokyo, Osaka and Nagoya)

(%)

year	shareholders											
		a		b	c	d	e		f	g	h	i
	number of companies	nutual-holdings	±	financial institutions (except a)	listed companies (except a/b)	overseas companies	with close	directors	ESOP	governments	institutional investors	others
1987	1,233	14.54	-	6.56	8.19	0.66	6.58	3.07	1.21	0.11	5.85	56.30
1988	1,268	14.79	0.25	6.31	8.08	0.67	6.66	3.09	1.16	0.10	6.46	55.80
1989	1,307	14.70	-0.08	6.18	8.12	0.61	6.81	2.84	1.10	0.09	7.73	54.66
1990	1,342	14.97	0.27	6.23	8.26	0.60	6.92	2.53	1.11	0.09	7.95	53.88
1991	1,381	14.84	-0.13	6.22	8.46	0.56	7.09	2.54	1.20	0.09	8.64	52.90
1992	1,387	15.05	0.21	6.20	8.33	0.56	7.04	2.53	1.34	0.09	8.64	52.76
1993	1,301	15.03	-0.02	6.27	8.12	0.58	5.95	1.98	1.31	0.09	10.08	52.55
1994	1,301	15.16	0.13	6.15	7.97	0.58	5.87	1.94	1.36	0.16	10.39	52.36
1995	1,322	14.89	-0.27	5.80	8.21	0.58	6.02	1.93	1.45	0.15	10.85	52.06
1996	1,356	14.65	-0.24	5.54	8.47	0.60	6.05	2.00	1.50	0.14	11.40	51.65
1997	1,393	14.29	-0.36	5.26	8.63	0.65	6.41	2.15	1.69	0.14	10.96	51.97
1998	1,405	13.41	-0.88	5.22	8.88	0.68	6.59	2.30	1.91	0.14	10.49	52.68
1999	1,459	12.56	-0.85	4.79	9.08	0.72	7.40	2.61	2.00	0.13	11.33	51.99
2000	1,523	11.64	-0.92	4.43	9.44	0.78	8.39	3.23	2.14	0.11	12.23	50.82
2001	1,549	11.21	-0.43	4.20	9.41	0.86	9.05	3.44	2.21	0.12	13.08	49.87
2002	1,570	10.09	-1.12	4.03	9.18	0.86	9.85	3.74	2.33	0.11	13.89	49.67
2003	1,594	9.75	-0.34	3.35	9.08	0.71	10.24	4.05	2.31	0.14	16.26	48.16
2004	1,687	8.87	-0.88	3.07	9.40	0.72	10.43	4.29	2.20	0.14	18.76	46.40
2005	1,734	8.70	-0.17	2.84	9.23	0.57	10.73	4.43	2.03	0.12	21.27	44.50
2006	1,768	8.65	-0.05	2.66	9.33	0.59	11.04	4.54	1.97	0.13	21.82	43.81
2007	1,759	8.71	0.06	2.79	9.48	0.53	11.06	4.57	2.01	0.12	21.29	44.01
2008	1,740	8.61	-0.10	2.90	9.47	0.54	11.20	4.42	2.20	0.13	18.96	46.00

	types of shareholders	definitions
a	mutual holdings	sum of stoks mutually held
b	financial institutions *	baks, life assurance, and casuallty insurance companies holding more than 3% shares, excluding mutually held shares (a)
c	listed companies *	listed companies except financial institutions (b) holiding more than 3% shares, excluding mutually held shares (a) listed companies include their non-listed subsidiary companies.
d	overseas companies *	overseas companies holding more than 3% shares
e	with close relationship e-1 directors e-2 domestic non-listed companies * e-3 others with close relationship	 directors and internal auditors, including management ownership plan domestic non-listed companies holding more than 3% shares overseas asset management companies and individuals hoding more than 3% shares
f	ESOP	employees stock ownership plan (ESOP), ESOP of customer companies
g	governments *	central and local governments, holding more than 3% shares
h	instututional investors domestic overseas	 penshon trust, investment trust, and trust by life asurnace companies calsulated subtracting overseas companies (d) and non-Japanese individuals who hold a large number sharea (e-3)
i	others	others such as individuals holding a pity shares

＊stands for the sum of those held more than 3% each.
Source: Keisuke Nitta, Sketch of the Resurgence of Mutual Shareholdings, NLI Research Institute report, Nissei Life Insurnce Research Institute, November 2009、P. 11)

income, type 2 to function (1) of information for business administration, and type 3 to function (3) to provide financial information to capital markets. Thus, each type of corporation needs the accounting principles or reporting standards that most reflect its ownership relations.

For type 1, its shareholders as business constituents claim their fair shares of annual profits, which should be calculated accurately and periodically. Directors, managers, employees, tax authorities, and other constituents claim for their shares based on current earned profit. Therefore, such profits, out of which dividends, manager bonus, director remuneration, wages, tax and other distributions are made, have to be verifiable and reliable. Profit and loss statement based on historical cost principle corresponds most to this requirement.

Viewing the dual nature of corporation from an accounting perspective, Littleton (1933, chapters 11–12) argued the relationship between the proprietorship theory and the entity theory. The proprietorship theory regards business as the property of the proprietor, while the entity theory stresses the separateness of business and the proprietor. In type 1, it can be said that the two theories are unified into the profit and loss statement where the profits are distributed among all constituents including shareholders as well as the corporation itself that keeps undistributed profit to be re-invested for capital accumulation.

Type 2 is a corporation of only a person, whose main objects are its growth and perpetual existence. Managers concern about recovery of capital employed in surplus. It is true that on planning phases, investment decisions are made to estimate net present value, internal rate of return and other criteria based on expected cash flows, nevertheless, the investment results, based on actual cash in-flow and out-flow per each project or in the aggregate, need to be verified for future decision making.

Jinnai (2011) mentions about Kazuo Inamori who is the founder of Kyocera Corporation. Inamori was invited to reconstruct the collapsed Japan Air Lines (JAL) and has succeeded to turn JAL into profit and in good shape.

> "Inamori regards accounting as 'core of management' in his major works on management and accounting", and he "came to rely on his management philosophy of 'do the right thing as a human being' to establish the company's own set of accounting principles composed of the following.
>
> 1 Principle of cash-based management
> 2 Principle of one-to-one correspondence
> 3 Principle of muscular management
> 4 Principle of perfectionism
> 5 Principle of doubt-check
> 6 Principle of profitability improvement
> 7 Principle of transparent management
>
> Each of these principles is not solely a formal accounting discipline, but also a substantial economic discipline by which an enterprise is regulated" (Jinnai, 2011, pp. 132–133)。

Jinnai (2011) further explains about the first principle "cash-based management" as follows:

> "'cash-based management' describes a simple management style based on the substance of things that focuses on cash flow or on managing business on the basis of cash flows." (p. 133).

To prove the accumulation of capital, cash flow statements are important as well as the scorekeeping function of management accounting. The accumulation implies the incremental circulation of initial cash investment, which is based on historical cost. The cash flow statements show how much cash was received or paid for operation, investment, and financing activities.

In type 3, the balance sheet measured by fair value is most useful for securities investors in stock market, who trades stocks considering if stock prices deviate from their fair value or intrinsic value. The fund managers may require, needless to say, more dividends to reimburse the administration costs of the fund or to finance the refund to withdrawers from the fund, however, finance theory shows that the value of a corporation is not affected by its dividend policy if there are no impediments such as transaction costs or taxes.

One of the important infrastructures of stock market is the role played by appraisers who conduct business valuation. However, it is noted that business valuation is a professional work and accounting information is useful but only a part of information employed by appraisers. During the fair market value appraisal process, data analyses such as economic analysis, industry analysis, subject company analysis, financial analysis, and financial statement adjustments are conducted before the application of valuation methods of market approach, asset approach, and income approach. The financial statement adjustments include normalization adjustments, comparability adjustments, non-operating/on-recurring adjustments, and other discretionary adjustments. In the last phases of application of valuation methods, premiums and discounts such as control premium, minority discount, key-person discount, and other appropriate adjustments are considered (Trugman, 2010).

> "Events of the past that are not expected to recur in the future should be disregarded, because the future is more important than the past" (Trugman, 2011, p. 13-7).

The securities investors in stock markets acknowledge the usefulness of accounting information measured by fair value, which, however, does not show the fair market value of the corporation. "Financial statements are an important and cost-effective source of information for investors, even though they do not report directly on future investment payoffs" (Scott, 2009, p. 87). It is the investors or professionals such as securities analysts and appraisers who do the valuation of the corporation.

Conclusion

Three types of stock corporations are identified based on its capital ownership relations through insight into the nature of corporation: type 1 business constituent shareholders, type 2 mutual holdings, and type 3 securities investors in stock market. Each type of stock corporations responds to the dominant accounting principle and accounting reporting form. Type 1 responds to historical cost principle and profit and loss statement, type 2 to cash flow based on historical cost principle and cash flow statement, and type 3 to fair value principle and balance sheet measured by fair value.

The historical development of Japanese stock corporations shows that the dominant type of stock corporations has changed from type 1, type 2, and then type 3 in its order. Therefore, the fundamental background of the Big Bang in Japan is the change of capital ownership relation from mutual holdings to securities investors in stock market, which caused the shift of dominant accounting principles from historical cost to fair value principle.

Though type 3 is dominant at present, other types coexist in the actual world. There are private, small and medium-sized, or domestic corporations other than listed, large, or global ones. Even within a corporation, various types of shareholders such as business constituent shareholders, mutual holdings, and institutional investors like fund trust, coexist. This fact implies that the distinct requirement for accounting information is its versatility to provide them with various types of information based on either historical cost principle, cash flow, or fair value principle.

Note

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