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LAWS AND REGULATIONS ON PROBLEM LOANS IN JAPAN

IS APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS POSSIBLE?

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I. INTRODUCTION

After almost 20 years of prosperity, the Japanese economy began to stagnate in the mid-1970s. A phenomenal bubble economy was created by the end of the 1980s (Table 1). After the bubble period, enormous bad debts were created in Japanese banks. As of 1999, a sum of 7.3 trillion yen of taxpayers' money was infused into the major banks. However, this infusion represents only the beginning of a solution. It is questionable whether or not the banks can survive severe worldwide financial competition.

Japan's banking policy administration, accused of failing to take effective measures against the deterioration of its banking system, is weathering heavy criticism. In the August 1995 annual report of the International Monetary Fund ("IMF"), [1] Japan's banking policy administration was criticized for failing to take effective measures to revive the deteriorating banking system. It was further suggested that "waiting would not recover the loss, but rather increase it," and Japan was asked to take speedy action to correct the problems in its banking sector. The report also stated that (1) market mechanisms that were supposed to help depositors and investors in selecting banks were not working because of the insufficient disclosure of operating information by the banks, and (2) it was necessary for the stockholders of the problematic banks to demand that the banks establish a more clear-cut rule to specify how the necessary funds, including public funds, be secured.[2]

[1] IMF, Annual Report, 1995, "International Market," p. 29.

[2] An article titled, "Japanese Disclosures Not Showing Real Pictures," appeared on the January 25, 1995 issue of Nihon Keizai Shimbun (Japan Economic Journal, hereafter "Nikkei") and discussed a way to solve the bad debts. It also referred to the IMF's report, *supra* note 1.

Table 1: Japan's Economic Growth Rates (Annual)[3]

(Unit %)

	Nominal	Real
1960-1970	16.82	10.45
1971-1980	13.12	5.22
1981-1990	5.49	3.97
1991-2000	2.30	1.73
2001-2003	1.65	1.03

Note: Nominal growth rates are adjusted by GDP deflators to get real growth rates.

In August 1999, it was revealed that the net asset deficiency of the Long Term Credit Bank of Japan, Ltd. ("LTCB"), for the quarter ending March 31, 1999, was ¥2.78 trillion.[4] The report[5] also highlighted the enactment of the Financial Revitalization Law[6] by Japan's government – a law intended to pave the way for the nationalization of asset-deficient banks and the subsequent transfer of their business to other banks. On September 28, 1999, the Financial Reconstruction Commission[7] decided to transfer LTCB to Partners,[8] a partnership led by the U.S. firm Ripple

[3] Cabinet Office, Government of Japan, Economic Statistics, *available at* http://www.cao.go.jp.

[4] Following the selection of the preferred acquirer of the LTCB on March 1, 2000, all common shares of the LTCB were transferred to New LTCB Partners C.V., an investment group comprising leading U.S. and European financial institutions and other investors. As a result, the temporary nationalization came to an end. On June 5, 2000, the LTCB changed its name to Shinsei Bank, Limited and began operations anew as a private bank under new management. To emphasize its new beginning, the bank selected the name "Shinsei," which in Japanese means "new birth." Shinsei Bank, Limited is now located at 1-8, Uchisaiwaicho 2-chome, Chiyoda-Ku, Tokyo, Japan with a capital of 451.296 billion yen and with 2122 employees. For details *see* http://www.shinseibank.com/investors/en/about/company/profile.html.

[5] *See* note 2 *supra*.

[6] The exact name of the law was "The Law Concerning Emergency Measures for the Reconstruction of the Functions of the Financial System (Law No. 132, 1998)." For details of the law, *see* http://www.fsa.go.jp/frc/hourei/hourei.html and http://www.dpj.or.jp/seisaku/zaisei/BOX2192.html.

[7] The Financial Reconstruction Commission (FRC) was merged into the FSA on January 6, 2001. The FRC had been working to restore the stability and vitality in the financial system through the quick resolution of failed financial institutions under the Financial Revitalization Law and capital injection into viable institutions using public funds under the Financial Function Early Strengthening Law (Law No. 143, 1998). With these efforts, the environment surrounding financial institutions had on the whole regained stability. For details, *see* http://www.fsa.go.jp/info/infoe/pamphlet_e.pdf.

[8] "Partners" was established as a partnership by Ripplewood Holdings, L.L.C., of the United States, and other leading international financial institutions as well as other investors with the aim of acquiring LTCB. All investor groups participating in "Partners" were expected to have a long-term view of the Bank's development and to sustain their investment for 10 -15 years or longer. Principle Investors in "Partners" are as follows:

Wood Holdings LLC. More than ¥4 trillion of public funds were invested into the bank to cover its bad loans as well as its secondary losses.[9]

Upon the announcement of the results of its investigation into 19 major banks,[10] and immediately after the enactment of the Financial Revitalization Law, the Financial Services Agency ("FSA") suddenly nationalized the Nippon Credit Bank, Ltd. ("NCB")[11] because the bank was net asset deficient. It is important to note that the net worth ratios of the LTCB and NCB were published at 10% and 8%, respectively.

The investigation and subsequent nationalization of NCB is what

Paine Webber (United States)	Travelers Investment Group, Inc. (United States)	Deutsche Banc Alex Brown (Germany)
Mellon Bank Corporation (United States)	ABN-Amro Bank (Netherlands)	The Bank of Nova Scotia (Canada)
Ripplewood Group (United States)	Banco Santander (Spain)	St. James Place Capital plc (United Kingdom)
GE Capital Commercial Finance, Inc. (United States)		

For details of "Partners," *see* LTCB's Annual Report, 1999, *available at* http://www.shinseibank.com/investors/ir/index.html.

[9] In view of the large loss amounts incurred in the disposal of non-performing assets, at the time of the termination of temporary nationalization, LTCB made an application for Special Financial Assistance (a monetary grant and a supplement to offset losses incurred in the conduct of the activities of a bank under temporary nationalization) to the Japanese Deposit Insurance Corporation (DIC). The total amount of this assistance was ¥3,588.0 billion. For details, *see* LTCB's Annual Report, 2000, *available at* http://www.shinseibank.com/investors/ir/index.html.

[10] The FSA was created as of July 1, 1997, with the integration of the Financial Supervisory Agency and the Financial System Planning Bureau of the Ministry of Finance. The new FSA has integral responsibility over planning of the financial system and supervision and inspection of financial institutions. In view of the rapid changes in the environment surrounding the economy and financial markets, there has been a focus on building a stable and vigorous financial system, and securing efficiency and fairness in the financial markets. In the supervision and inspection of financial institutions, further efforts to maintain and improve the soundness of financial institutions have been made. Coordination with foreign financial authorities has been strengthened in order to cope adequately with the globalization of finance. For the details of FSA *see* http://www.fsa.go.jp/info/infoe/pamphlet_e.pdf.

[11] On December 13, 1998, NCB was notified of the decision by the Prime Minister to initiate Special Public Management of NCB pursuant to the Financial Revitalization Law (Law No. 132 of 1998). As a result, NCB was nationalized and all of its shares were acquired by the Deposit Insurance Corporation (DIC) on December 17, 1998. A new management team was appointed by the DIC effective December 25, 1998. On September 1, 2000, NCB ended its period of special public management that began on December 13, 1998 upon the closing of a Share Purchase Agreement dated June 30, 2000 for the transfer of the Bank's stock by the DIC to an investment group consisting of SOFTBANK CORP., ORIX Corporation, the Tokio Marine and Fire Insurance Co., Ltd., and other financial institutions. Operations of the new privately owned bank started on September 4, 2000. On September 5, 2000, NCB applied for an enhancement of capital in accordance with the Financial Function Early Strengthening Law (Law No. 143 of 1998) and submitted a Business Improvement Plan to the Financial Reconstruction Commission. NCB changed its name to Aozora Bank, Ltd. on January 4, 2001. Aozora Bank, Ltd. is located at 1-3-1, Kudanminami, Chiyodaku, Tokyo, Japan with the capital of 419.8 billion yen and 1404 employees. For details of Aozora Bank, Ltd., *see* http://www.aozorabank.co.jp/en/company/corporate/overview.

triggered the criticism that Japanese banks were not disclosing their operations accurately. [12] This article investigates the methods for processing bad loans and the disclosure practices of Japanese banks. Cases of recent bankruptcies in Japan (i.e. The Long-term Credit Bank and the Nippon Credit Bank) are closely examined. This article also examines both the legal requirements and the accounting standards behind them. It seems that there are systems as well as rules and regulations unique to Japan that are substantially different from international standards. The purpose of this article is to describe the generally accepted accounting practice ("GAAP") of Japanese banks in comparison to the GAAP of the U.S. and illustrate the shortcomings of the Japanese financial reporting system. Due to weak banking regulations, Japanese banks ignored the issue of problem loans for too long. The article intends to point out precisely where the problems are and propose ways to rectify the situation.

With the world's second largest GNP, Japan is still an economic giant, making it important at a global level for it to achieve full recovery of its economy. Proper disposal of bad loans held by Japanese banks is critical to that recovery. The IMF is also keeping a close eye on how Japan is planning to take care of this problem.

II. THE DEMISE OF THE HIGH GROWTH PERIOD AND BIRTH OF THE BUBBLE ECONOMY

After enjoying almost 20 years of prosperity with an average annual growth rate of 10% or higher, the Japanese economy began to stagnate in the mid-1970s. In particular, in 1974 and 1975, Japan suffered the so-called "oil shock" which triggered the first recession since World War II.

In the meantime, based upon the belief, shaped by Japan's post-war experience, that high rates of economic growth are the norm, the Japanese government and industries pushed for further economic growth. Undemanding monetary and fiscal policies on the part of the government and flexible investment policies on the part of industry resulted in the creation of a hefty domestic demand further exacerbated by a large volume of government bond issues and a torrential flow of exports to overseas markets.

As a result, the end of the 1980s saw a phenomenal bubble economy of historic proportions. The root causes of the bubble were: (1)

[12] For the differences in disclosure systems between the U.S. and Japan, *see* Mitsuru Misawa, "Daiwa Bank Scandal in New York – Its Causes, Significance and Lessons in the International Society," Vanderbilt Journal of Transnational Law, Vol. 29, No. 5, 1996.

an enormous quantity of funds accumulated in industry; (2) the advancement of financial liberalization and internationalization, the financial and capital markets grew to such huge sizes that it became easier for industry to acquire funds from such markets and reduce its reliance on banks; and (3) faced with this "loss of loyalty" from their traditional customers, the banks increased their lending to the real estate industry and their involvement in stock investment schemes.

During the high growth period preceding the bubble, the huge demand for capital investment funds was met by loans from banks because the securities market, the essential function of which is to meet such demands, was not yet fully developed. When high growth slowed down, the demand for capital investment itself receded, and what little demand for funds existed could be satiated by the securities market, particularly overseas markets, much more cheaply. This situation led to a substantial reduction in the number of customers for the banks. Later, during the bubble period, all the industries were able to borrow money at very low rates from the markets to pay back the money they owed the banks. Thus, it became vital for the banks to find profitable lending targets for the sake of their own survival. What they found was real estate financing secured by land, which at that time was valuable collateral.

After the bubble period, enormous bad debts,[13] amounting to ¥81 trillion, were created. This amount constituted 15.3% of the GDP of Japan (the GDP was ¥524 trillion in 1997).[14] Yet perhaps we should not be too critical of the banks' attempt to profit from ever larger loans backed by real estate when land prices were increasing. The truth of the matter is that nobody could foresee that land prices could drop as much as they did.[15]

However, as a practical matter, the amount of the bad debt was so large that the Japanese government could not simply ignore the problem in the hope that market mechanisms would take care of them. Even if the market were able to cure the problem, it would take too long and the financial system might not survive. Thus, infusing public funds in some manner became unavoidable.

Consequently, the infusion of public funds into the banks became a national imperative. In other words, the financial instability and the

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[13] As to the definition of "bad debt," *see* "Severity of the Crisis as Indicated in Key Words," Shukan Toh-yo Keizai (Weekly Oriental Economist), Feb. 2, 1998, p.46. As to its implications, *see* "Reality of Banks' Bad Debts," Shukan Toyo Keizai, April 4, 1998, pp.38-40, *available at* http://www.orientaleconomist.com/aboutus.

[14] *See* Toyokeitai, Economic Statistics, p. 14.

[15] As to the details of the land price drop in Japan, *see* "Why Banks Made Big Mistakes?" Shukan Toh-yo Keizai, March 28, 1998, pp.30-34.

economic downturn combined to bog down the Japanese economy. Japan saw negative growth rates two years in a row, in 1997 and 1998, and the jobless rate remained near 5%.

In 1997, public concern about instabilities in some of the major banks' operations was heightened. Many banks became unhealthy under the burden of their debt. The value of stocks held, which is counted as part of bank's owned capital in Japan, declined due to the drop in stock prices in the market. In order to maintain the minimum rates (8%), the banks accelerated the compression of assets, such as the lending balance, that constitutes the denominator for the BIS ratio of owned capital.[16] This compression caused a sharp credit contraction due to banks' reluctance to lend and their inability to collect on the loans, resulting in an abnormal situation in which the total loan balance of the banks across the nation decreased compared to the previous year.[17]

At this point, even some otherwise financially sound industrial corporations experienced temporary fund shortages. Without an influx of funds, industry cannot initiate new capital investments. Therefore, the entire economy began to head toward a diminishing equilibrium. The basic cause for the long economic downturn, then, was the banks' contraction of credit.

In order to escape from this new form of "compound recession," it was necessary to cure the problems in the financial sector. What was hampering the recovery in the financial sector were the burdensome bad debts encumbering the financial institutions. Wiping out the bad debts from the books of the financial institutions came to be recognized as an essential act necessary for the recovery of the Japanese economy as a whole. The Japanese Big Bang[18] reform program and other related reforms of the financial sector were also recognized as necessary preconditions.

Despite the fact that it has been ten years since the bubble economy burst and nearly ten years since public funds in the total sum of ¥7.2 trillion were poured into many of the major Japanese banks in early 1999 (with the intention of strengthening their net worth capital), the financial figures of major banks at the end of December 2003 – including the seven major city banks – have yet to show signs of complete recovery.

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[16] As to "BIS Ratio of Owned Capital," *see supra* note 15 at p.43. The BIS (The Bank of International Settlement) ratio is defined as Owned Capital/Total Assets. The BIS represents the healthiness of the banks. All the international banks in the world are requested to maintain a BIS of 8% at a minimum.

[17] As to the details of the "reluctance to lend" phenomenon, *see supra* note 15 at p. 49.

[18] As to the "Japanese Big Bang," *see* Shukan Toh-yo Keizai, July 25, 1998, p.43. As to its reality, *see* "Big Bang Seeing the First Sign of Realization with the Public Fund Infusion," February 2, 1998, pp.10-13.

All of the major banks continue to hold huge bad loans (see Table 2). Prior to 1997, ¥685 billion of tax money was used to liquidate the special housing loan companies ("Jusen") which were also burdened with enormous debts. At that time, it appeared as though that amount would suffice to settle the banks' bad debts, but it turned out that the Japanese Government had merely only begun to resolve the problem.[19]

Table 2: Bad Loans of Major Japanese Banks[20]

(As of December 2003)

(unit:¥100 million)

Bank	Bad Loans Outstanding
Mizuho Financial Group	37,156 (-14.3)
UFJ Financial Group	33,751 (-8.9)
Mitsui Sumitomo Bank	33,226 (-14)
Risona Bank	26,925 (-16.3)
Mitsui Trust Bank	5,520 (-16.1)
Sumitomo Trust Bank	3,358 (-9.8)
Mitsubishi Tokyo Bank	N/A

Note: Figures in parentheses indicate percentage changes from September 2003.

III. BAD LOANS UNDER PROLONGED BUSINESS STAGNATION IN JAPAN

The Economic Planning Agency ("EPA")[21] insists that the major cause of the current downturn in the Japanese economy has been the delay in the disposal of bad loans by financial institutions. This delay was primarily caused by the private sector and the government. It is said that

[19] As to the details of the Jusen (special housing loan companies) problems, *see* Mitsuru Misawa, "Lenders' Liability in the Japanese Financial Market - A Case of Jusen, the Largest Problem Loan in Japan," Management Japan, Vol. 30, No. 2, Autumn 1997, pp. 18-28 and Vol. 31, No. 1, Spring 1998, pp. 19-28.

[20] Nikkei, February 6, 2004, p.7.

[21] In 1997, the Economic Planning Agency (EPA) was absorbed into the Cabinet Office of the government as a result of the restructuring of Japanese government agencies. Most of the information about the EPA can be found in the web site of the Cabinet Office *available at* http://www.cao.go.jpabout=cao/index-e.html.

the reasons for the delay include: (1) optimism that merchandise and land prices would eventually rise again; (2) a failure on the part of the banks to take necessary action in line with their traditional conservatism and tendency to wait to see what others would do; and (3) that the financial institutions failed to sufficiently disclose information. [22]

At the same time as the EPA made its announcement to this effect, the FSA published the results of its investigation into the 19 major banks (including LTCB and NCB) conducted during the period of July through September 1998. The investigation revealed that the evaluations of bad loans by the banks themselves were generally loose and that the total shortage in the loan loss reserves reached as high as ¥5.40 trillion.[23]

In an article that appeared in April 2001, the Nikkei stated that, according to an FSA estimate, a sum of approximately ¥150 trillion had been loaned to questionable borrowers. In essence, this article revealed that in addition to a sum of ¥81 trillion in questionable loans as previously identified by the FSA, [24] ¥70 trillion continued to be lent out to questionable borrowers afterwards.

In September 2001, Mycal Corporation, [25] a failing Japanese retailer with debts of ¥1.74 trillion that had applied for court-mandated protection under the Civil Rehabilitation Law,[26] was reportedly classified by its main banks as a borrower requiring caution, as its provision rate of loan loss reserves was believed to be no more than 3-5%. [27] This provision rate of 3-5% was obviously too low. Although banks claimed that this 3-5% provision rate was estimated based upon the rate of lending loss in the past, it is questionable due to the following reasons:

(1) the rate of lending loss in the past has little significance when facing an unusually large amount of bad loans, which Japanese economy has never previously experienced, and

(2) the uncollectible amount of the loan, which determines the level of the provision rate, is based upon case by case estimations of future refunding resources.

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[22] *See* Economic Planning Agency, "Retrospect and Tasks of Japanese Economy," December 27, 1998 *available at* http://www5.cao.go.jp/98/f/19980717wp-keizai.html.

[23] Nikkei, April 8, 2001, p. 3.

[24] *See supra* note 15.

[25] At the time of the application, Mycal Corporation was located in Osaka, Japan with the capital of ¥74 million and with 20,178 employees. For details, *see* http://www.mycal.co.jp

[26] Law No. 225 of 1999, *as amended* to Law No. 128 in 2000. For details, *see* http://www.ron.gr.jp/law/law/minji_sa.htm.

[27] Nikkei, September 15, 2001, p. 1.

As can be seen from this example, all parties involved in the issue of reserves for bad debts (the FSA, financial institutions, and auditors) were governed by old corporate accounting principles that did not take the new economic context into account.

A closer look at NCB showed an asset deficiency of ¥94.4 billion as at the end of the 1998 fiscal year (March 1998); a net asset deficiency, including the unrealized loss of negotiable securities, at ¥274.7 billion; and a net worth of zero. These numbers are all derived from the FSA's report released in December 1998.[28] Yet NCB announced in its public disclosure statement released at the end of the 1998 fiscal year that its net worth ratio was 8%. It is clear that there was a significant difference between the numbers released to the public by the bank and the numbers uncovered by the FSA.

More importantly, it was reported that NCB, which was under special state control, had an asset deficiency of approximately ¥3 trillion as at December 1998 (the time at which the bank was placed under state control).[29] This ¥3 trillion asset deficiency was ten times larger than the ¥274.7 billion asset deficiency made public by the bank at the end of the 1998 fiscal year. Again, there is a large discrepancy between the publicized data and the actual data.

Once this ¥3 trillion asset deficiency was revealed, the Japanese government decided to infuse a sum of approximately ¥3.5 trillion in public funds in to NCB and transfer the control over NCB to domestic financial institutions including SOFTBANK Corporation and ORIX Corporation.[30]

IV. JAPANESE ACCOUNTING REGULATIONS ON BAD LOANS

Since an enterprise operates based on the profit ratio of its capital, it must regularly identify the change in its assets and the profit/loss results. For a joint-stock corporation in which a plurality of stockholders participate with the common goal of sharing in the earned profit of the corporation, the only collateral for creditors is the assets of the corporation. Accounting, which is the technique of recording the performance of a business objectively and accurately, is not only necessary for the rational management of the corporation but is also

[28] Nikkei, December 14, 1998, p. 1.
[29] Nikkei, June 13, 1999, p. 4.
[30] Nikkei, March 7, 2000, p. 7.

necessary for the protection of stockholders and creditors. Given the diverse uses to which corporate accounts are put, the accounting rules must incorporate regulations established to accommodate the different purposes of three different laws: the Commercial Code,[31] Securities Exchange Law,[32] and the Corporate Tax Law.[33]

The Securities Exchange Law in Japan was enacted as a precondition imposed by the occupation authorities to the reopening of the securities exchanges. The Japanese law is a modified version of the Securities Act of 1933[34] and the Securities Exchange Act of 1934[35] of the U.S. and contains provisions substantially similar to those found in the U.S. laws for the disclosure of corporate information and for the regulation of the securities markets. However, the pattern of securities regulation in Japan differs somewhat from that of the U.S. since the Japanese Commercial Code also contains disclosure and regulatory provisions. The Commercial Code was transplanted from Germany in 1899 as part of the general acceptance of German civil law during the Meiji era.[36] During the period of occupation, SCAP[37] reformed the Commercial Code, with the intention of adopting the Anglo-American common law approach to corporate law.

Accounting regulations in Japan also derive from both the Commercial Code and the Securities Exchange Law. The duality of accounting regulations is due, in large part, to their historical development. The Commercial Code regulates corporate accounting procedures[38] for the primary purpose of accurately determining the amount available for dividends so that the position of creditors would not be jeopardized by the impairment of corporate properties resulting from excessive dividend distributions. In 1950, pursuant to the Securities Exchange Law, the "Regulations Concerning Terminology, Forms and Method of Preparation of Financial Statements" ("MOF Ordinance") were

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[31] Law No. 48, enacted on March 9, 1899, amended 18 times (hereafter cited as the Commercial Code). For details, *see* http://www.ron.gr.jp/law/law/syouhou1.htm.

[32] Law No. 25, enacted on April 13, 1948, amended 27 times, (hereinafter cited Securities Exchange Law). For details, *see* http://www.houko.com/00/01/S23/025.htm.

[33] Law No. 34, enacted on March 31, 1965, amended many times, (hereinafter cited the Corporate Tax Law). For details, *see* http://www.houko.com/00/01/S40/034.htm.

[34] 15 U.S.C. §§ 77a-77mm (1934), *as amended.* 15 U.S.C. §§ 77a-77m (1970).

[35] 15 U.S.C. §§ 78a-78jj (1934), *as amended.* 15 U.S.C. §§ 78a-78hh(1) (1970).

[36] Subsequent amendments to the Code in 1899, 1911, and 1938 in the field of corporation law mainly reflected German developments. *See* K. Shida, Nihon Shohoten No Hensan To Sono Kaisei (Codification of Japanese Commercial Code and its Amendments) (Meijidaigaku Shuppanbu 1934).

[37] The official name of the occupation authorities is the General Headquarters for the Supreme Commander for Allied Powers (commonly termed SCAP).

[38] Commercial Code, Articles 281-95.

promulgated.[39] In 1963, a separate set of regulations, "Regulations Concerning Balance Sheet and Income Statements of Corporations" ("Ministry of Justice Ordinance"),[40] were issued to complement the accounting regulations specified in the Commercial Code. The Ministry of Justice Ordinance was applicable to all companies. At that time, the accounting regulations were probably more sophisticated than those in any other country including, in some respects, those in the U.S. Unfortunately, serious problems arose in Japan as the result of discrepancies between the dual accounting regulations. The problems created by this dual system are exemplified in the regulations governing bad debts.

A. The Commercial Code

The Code uses the period profit and loss calculation method, and requires the balance sheet to be prepared directly from the accounting books using the derivative method.[41] Although detailed regulations concerning the accounting procedures to be used by a corporation could be found in the Commercial Code,[42] the rules of the Commercial Code's General Regulations Concerning Commercial Books[43] and other Ministry

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[39] Japan, Ministry of Finance Ordinance No. 18 (Sept. 28, 1950), *as amended*, Japan Ministry of Finance Ordinance No. 59 (Nov. 27, 1963) (hereinafter Ministry of Finance Ordinance).

[40] Japan, Ministry of Justice Ordinance No. 31 (March 30, 1963) (hereinafter Ministry of Justice Ordinance).

[41] Commercial Code, Article 33 provides,

1. The following matters shall systematically and clearly be stated in the accounting books:
   (1) Business properties and values thereof at the commencement of business and once in each year at a fixed time, as for a company, business properties and values thereof at the time of incorporation and at each settlement of accounts;
   (2) Transactions and other matters that give influence to business properties.
2. A balance sheet shall be prepared based on accounting books at the time commencement of business and once in each year at a fixed time; and a company shall prepare it based thereon at the time of incorporation and at each settlement of accounts.
3. A balance sheet shall be compiled and bound together, or shall be entered in a book specially kept for that purpose.
4. A balance sheet shall contain the signature of the person who prepared it.

[42] Commercial Code, Article 281 provides:

1. The Directors shall prepare the following documents and the annexed specifications thereof every period for settlement of accounts:
   (1) A balance sheet; (2) A profit and loss account; (3) A business report; (4) Proposals relating to the reserve fund and the distribution of profits or interest.
2. The documents under the preceding paragraph need be audited by the auditors.

[43] Commercial Code, Articles 32-36. Commercial Code, Article 32 provides:

of Justice Ordinances[44] were applied to items that were not specifically defined in those regulations. It is then requested that Japanese fair accounting practices (also known as generally accepted accounting principles, "GAAP") be considered when interpreting the existing rules.[45]

The rules of the Commercial Code regarding bad loans specified that if there were concerns about the ability to collect the money claims recorded in the liquid asset category, then they should be recorded in such a manner as to deduct the estimated uncollectible amount ("bad loan reserve") for each item related to each money claim, or that the account should show only the balance after deducting the estimated uncollectible amount and the estimated uncollectible amount should be displayed as a footnote.[46] It was also stipulated that if a reserve was to be accounted for with respect to an amount that was expected to be uncollectible, the reserve was not necessarily categorized as a liability in the legal sense. Instead, it was categorized as a reserve prepared for a specific expense in the future or an estimate of a cost. So defined, it was allowed to remain a reserve placed within the liabilities and accompanied by a specific label indicating its significance.[47]

The Commercial Code provided no more guidance in these matters than what is discussed above. Moreover, there were no other specific rules, other than those found in the Japanese GAAP, that provided instructions for the handling of bad loans. This lack of specificity allowed corporations to account for bad loans as they wished.

B. The Securities Exchange Law

The Securities Exchange Law stipulates the terms, formats and

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1. Every trader shall prepare accounting books and balance sheets for making clear the conditions of business properties and profit and loss.
2. In construing the provisions concerning preparation of the books of account, authentic accounting practices shall be taken into consideration.

[44] *See* Ministry of Justice Ordinance, *supra* note 40.

[45] Commercial Code, Article 285-4 provides:

1. The monetary claims shall be valued at the nominal amount thereof; provided that, of they were purchased at the proceeds lower than the nominal amount or there is any reasonable ground, they shall be valued with reasonable decrease.
2. If there is a fear of it being impossible to collect the monetary claims, the estimated amount being impossible to collect shall be deducted in valuation.

[46] Commercial Code, Article 287-2 provides;

1. When the preparation money is accounted on the debit side of the balance sheet for preparing against a specified defrayal or loss, the purpose thereof shall be made clear in the balance sheet.
2. If the preparation money under the preceding paragraph is used for the purpose other than its proper purpose, the reason shall be stated in the profit and loss account.

[47] Commercial Code, Article 287, Section 2.

procedures to be used in the preparation of a balance sheet, a profit and loss statement, and other documents related to financial calculations.[48] Items that are submitted in accordance with the law also have to be prepared in accordance with the rules generally recognized as fair and reasonable using the terms, formats and method of preparation specified in the MOF Ordinance.[49]

The MOF ordinance is essentially based on the assumption that issuing companies are obligated to submit financial calculation documents.[50] From a more practical standpoint, financial calculation documents are expected to provide material information required to evaluate such things as negotiable securities as well as a variety of performance indicators when the company engages in share placement or the public offering of stocks. Based on this, the ordinance favors regulating representations in such a way that they be prepared based on a non-interruptive, uniform standard so that period and position comparisons can be easily performed. This ordinance is aimed at increasing the efficiency of administrative investigation. It also increases the fairness of transactions by providing more accurate representations to investors in a more rational and easily comparable manner. In short, a high priority is placed on "consistency" of format.

Subsequent MOF ordinances (the Rules on Financial Statements,[51] the Rules of Consolidated Financial Statements,[52] and the Rules of Intermediate Financial Statements[53]) stipulated that any issues left unspecified are expected to be resolved by reference to the Japanese "corporate accounting practices" generally accepted as fair and reasonable (*i.e.* the GAAP). For example, the Rules on Financial Statements explained, "[t]he items that are not defined in these rules shall follow the corporate accounting practices generally accepted as fair and reasonable."[54] The concept of the "corporate accounting practices generally accepted as fair and reasonable" mentioned here matches the concept of the GAAP under the Commercial Code.

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[48] *See supra* note 39. For the development of Tokyo Stock Market, see Mitsuru Misawa, "Tokyo as an International Capital Market – Its Economics and Legal Aspects", 8, Vanderbilt Journal of Transnational Law, 1-38 (1974).

[49] Article 193; *see supra* note 40.

[50] Article 24 of the Securities Exchange Law stipulates that the issuer of securities must submit a Securities Report (Yukashoken Hokokusho).

[51] The MOF Ordinance No. 36, issued on November 27, 1963. For details, *see* http://www.mof.go.jp/hourei.htm.

[52] The MOF Ordinance No. 28, issued on October 30, 1976. For details, *see* http://www.mof.go.jp/hourei.htm.

[53] The MOF Ordinance No. 24, issued on March 30, 1999. For details, *see* http://www.mof.go.jp/hourei.htm.

[54] Article 1-1 of the Rules on Financial Statements. *See supra* note 51.

While the GAAP for bad loans based on the Securities Exchange Law defined the standards for processing bad loans, it does not require companies to disclose specific, detailed information via footnotes. The Securities Exchange Law was introduced after World War II, and at that time, was developed by copying the same laws established in 1933 and 1934 in the United States.[55] The problem stems from the loose definition of corporate accounting principles and other rules that are necessary for the full implementation of the law. Japanese accounting principles have yet to be developed to reach the international standard.

C. The Japanese GAAP

As has been discussed, the Commercial Code and the Securities Exchange Law are reliant on the development of a comprehensive GAAP for proper implementation. The next step, then, is to delineate the Japanese GAAP.

The Japanese GAAP standard was incorporated in the "Corporate Accounting Principles"[56] established in 1949 based on the Commercial Code.[57] More specifically, the "Corporate Accounting Principles" were generated in an interim report issued in 1949 by the Corporate Accounting Rule Investigative Committee within the Economic Stabilization Agency[58] and the "Annotations to Corporate Accounting Principles" in an interim report issued in 1950 by the Corporate Accounting Council of the Ministry of Finance ("MOF").[59] The philosophy of the Corporate Accounting Principles emphasizes the profit and loss calculation for each accounting period and assumes that the corporation is a going concern.

According to its preamble, "the Corporate Accounting Principles consist of the summary of practices recognized as generally fair and

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[55] They are the United States Securities Act of 1933 and of the Securities Exchange Act of 1934. *See* 15 U.S.C. §§ 77a-77mm (1934), *as amended*, 15 U.S.C. §§ 77a-77mm (1970) and 15 U.S.C. §§ 78a-78jj (1934), *as amended*, 15 U.S.C. §§ 78a-78hh(1) (1970). *See also* Mitsuru Misawa, Securities Regulation in Japan, 6 Vanderbilt Journal of Transnational Law, 447-510, (1973), on the history of how the Japanese Security Exchange Law was established.

[56] July 9, 1949, *as amended* in July 14, 1954, November 5, 1961, August 30, 1972, and April 20, 1980 (hereinafter Corporate Accounting Principles). For details, *see* http://www.ron.gr.jp/law/etc_txt/kigyokai.htm.

[57] Law No. 48, enacted on March 9, 1899, *as amended* 18 times (hereafter the Commercial Code). For details, *see* http://www.houko.com/00/01/M32/048.HTM.

[58] The Economic Stabilization Agency was established in the government as a control organ to restore the Japanese economy after World War II in 1946 and was abolished in 1952 since it finished the functions. *See* http://accountare.com/kigyoukaikeigenshoku_1st.html.

[59] The Ministry of Finance was reorganized on January 6, 2001. The name was changed from Okurasho to Zaimucho in Japanese, but the English name remains the same. For more information about the reorganization, *see* http://www.mof.go.jp.

reasonable among those practices evolved within actual corporate accounting works and they represent the rules to be abided by corporations in processing their accountings without really having to be regulated by the laws and regulations."[60]

A description in the Corporate Accounting Principles entitled "On Reserves" states, "when there is a specific expense or loss that may result from a phenomenon occurring prior to the current term, whose probability of occurrence is high, and whose amount can be logically estimated, the amount that belongs to the burden of the current term is accounted for as the current term's expense or loss in the reserve, and the balance of said reserve is written on the debt side or the asset side of the balance sheet."[61] It also lists 11 items, including loan loss reserves, as examples. In addition, it states that "no reserve can be accounted for expenses or losses concerning a contingent phenomenon for a low probability of occurrence." These comments together represent the extent of the accounting standard and no other specific rulings are in existence. Clearly, these comments are too simple and incomplete to be considered an adequate accounting standard.

Consequently, since Japanese GAAP is insufficient, in practice it has been customary to honor traditional accounting procedures. The effect of this practical reality is that companies simply tended to follow what other companies were doing. This practical reality did not present any major problems during the heady period of economic growth following World War II, but the exact same practices have caused problems in more recent years because traditional procedures were loosely defined in all of the financial statements of every institution and enormous loan losses were thereby created in a manner never before experienced. In particular, in common use was a backward calculation of "amortization source assets"[62] (such as unrealized stock profits). In other words, the total amount of funds that could be allocated for reserves were first determined, followed by an assessment of bad loans while adjusting the reserves so that they could fit into the range. Therefore, it was impossible for a bad loan to be processed in a manner that would exceed the amortization source assets.

The Corporate Accounting Principles are authoritative in Japan.

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[60] *Supra* note 58.

[61] Corporate Accounting Principles, Art. 18.

[62] *See* "BOJ and FSA, Which is Wrong?" by Tsuyoshi Kimujra, pp. 118-125. Bungei Shunju, October 2001 issue. According to the author, a strange phenomenon is that the total amount of reserve is decreasing while the remaining balance of the bad loans is increasing, exemplifying the abovementioned condition occurring in the actual process. He also criticizes the Japanese banks for unduly delaying the clean up process of the bad loans.

For example, as long as a company's accounting is done in accordance with the Corporate Accounting Principles, then an auditor must perforce issue a favorable opinion. Therefore, it can be safely assumed that the root cause of the delay in determining the amounts of bad loans was in the simplistic and inexact approach of the "Corporate Accounting Principles." Note that if the U.S. accounting standard regarding bad debt reserves had been applied, a loan balance, after deducting reserves, must be specified in a "net realizable value" account.[63]

An accounting standard, from an international standpoint, is a rule generally accepted internationally and aimed at the proper representation of fair and legal accounting practices. It is not something that should evolve over time through practice, but rather something that should be constituted by a sound theoretical basis tied to the goal of providing proper information disclosure. The accounting standards used in the U.S. and Europe are researched and upgraded constantly by permanently established organizations to keep up with economic changes and trends. The Japanese Corporate Accounting Principles, developed more than half a century before, have become extremely divergent from current international standards and can no longer be deemed fit for today's economy.[64]

The problem is that even the Japanese government, in the form of the FSA, continued to honor existing these inexact Corporate Accounting Principles. The FSA also provides administrative services through the Corporate Accounting Rule Council,[65] which prepares the accounting principles. In addition, the FSA also includes the Banking Supervisory

[63] "Net Realizable Value" is a method of determining the present value of a troubled asset to its present owner based on the assumption that the asset will be held for a period of time and sold at some future date. The present value includes future earnings and the asset is expected to generate, less the cost of owning, holding, developing and operating the asset. To compensate for these costs, the asset's projected future net cash flows are discounted using a formula that incorporates the cost of capital (the cost of paying dividends and interest). Net realizable value, therefore, is based on a formula incorporating what the asset must earning order to pay for its share of the costs of running the business. Net realizable value is one accounting method used to calculate the present value of an asset (a loan) at some point after the loan has become past due and a book value is no longer valid. The synonym is "fair value". For the discussion of "fair value" measurements by FASB, *see* http://www.fasb.org/project/fv_measurement.shtml.

[64] The term "accounting principles" is not a term recognized internationally. It is called "Financial Accounting Standards" in the United States, and will be called "International Financial Reporting Standards (IFRS)" by the International Accounting Standard Board (30 Cannon St. London EC4M 6XH, U.K. hereafter, "IASB.") in its new standards still to be published. For the details of IASB, *see* http:// www.iasb.org.uk.[65] It was established in the government as a control organ to restore the Japanese economy after World War II in 1946 and was abolished in 1952 since it finished the functions. *See* http://www.nira.go.jp/pubj/seiken/v08n07.html.

Agency.[66] The FSA has clearly long been in a position to improve the accounting principles once problems were identified. The biggest barrier, in hindsight, to their doing so was the fact that they did not recognize the importance of a revised accounting standard.[67]

Also noteworthy is that publicly disclosed financial statements of some Japanese companies are required by the U.S. to include a special legend on the front page.[68] The legend, to be written in English, was to state something along the lines of the following: "This is prepared in accordance with the Japanese Securities Exchange Law and accounting standards, and not under the accounting standards of any other country."[69] This requirement was imposed by the U.S. because the Japanese accounting process was no longer trusted internationally due to Japan's closed-mindedness and its insensitivity to what was happening internationally.[70] The problem does not lie with the corporations forced to write such statements, but rather is a result of the antiquated accounting system. The parties who were negatively affected as a result of these poor

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[66] The Banking Supervisory function was previously performed by the MOF and this function is now switched to the FSA. For the new FSA, *see supra* note 10.

[67] Prime Minister Koizumi frequently conferred with the Minister of the FSA, Yanagisawa, in order to press forward on the fundamental clean up of the bad loan problem as his pet project of the reform he is pushing. The FSA resisted the change claiming that they "cannot issue policies that contradict with the traditional financial administration policies and accounting principles," which clearly shows FSA's poor understanding of the bad loan problems. For details, *see* Nikkei, September 21, 2002 p. 3.

[68] "This inclusion of the legend was requested by the Big 5 accounting firms of the U.S. For the details of the backgrounds of the requestors, *see* http://glovia.fujitsu.com/jp/cybersmr/e4-1.html.

[69] The following is an example of a legend. "Summary of Significant Accounting Policies. The basis of presentation, Nissan Motor Co., Ltd. (the "Company") and its domestic subsidiaries maintain their books of account in conformity with the financial accounting standards of Japan, and its foreign subsidiaries maintain their books of account in conformity with those of the countries of their domicile. The accompanying consolidated financial statements have been prepared in accordance with accounting principles and practices generally accepted in Japan and are compiled from the consolidated financial statements filed with the Minister of Finance as required by the Securities Exchange Law of Japan. Accordingly, the accompanying consolidated financial statements are not intended to present the consolidated financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries and jurisdictions other than Japan." For details, please obtain a pdf file of Nissan's Annual Report from the Nissan home page on the internet. The legends of cautionary statements can only be found in the English version of financial statements based on the Japanese Securities Exchange Law, not in any financial statements of SEC registered companies prepared based on the U.S. Accounting Standards. *See*, for example, Nissan Motor's Annual Report, 2002, p. 57 (*available at* http://www.nissan-global.com/EN/DOCUMENT/PDF/AR/2002/a/2002.pdf).

[70] Nippon Keidanren (Japan Business Federation, equivalent to the Business Round-table in the U.S.), in which its mission is to achieve a private sector-led, vital, and affluent economy and society in Japan, for which it is demonstrating its leadership in setting the path for the country, is officially against the inclusion of the legend, and advocates the necessity of internationalizing Japanese accounting standards. For Nippon Keidanren's announcement of the issue, *see* http://www.keidanren.or.jp/japanse/policy/2001/013/honbun.html. For the Keidanren, *see* http://www.keidanren.or.jp/english/profile/pro001.html.

accounting standards were the corporations, because they are not trusted by potential investors, and the investors (users of the financial statements), because they were thereby unable to obtain accurate financial information.

D. Dual Regulations on Bad Loans

When compared, the following differences between the Commercial Code and the Securities Exchange Law can be found:

(1) There is a difference in the orientation toward consistency in the accounting procedures regarding bad loan reserves. The MOF Ordinance (promulgated under the Securities Exchange Law) clearly emphasizes consistency over time regarding matters of content and format in financial statements, [71] but the Ministry of Justice Ordinance (promulgated under the Commercial Code) permits changes in accounting methods providing that the changes are noted via footnote.[72] Meanwhile, under the provisions of the Ministry of Justice Ordinance, two views are possible. One view is that the ordinance relies on the footnote procedure to maintain consistency. The other view is that the ordinance permits changes in accounting procedures – something not usually in concert with an emphasis on consistency and usually not permitted unless good reason is provided – so long as such changes are flagged via footnote. The Ministry of Justice Ordinance thus seems to allow the banks a great deal of flexibility on the issue of accounting for bad loan reserves.

(2) There are differences in equity structure requirements. Under the Commercial Code, companies need to set aside at least 1/10 of the profits subject to cash dividends in an earned surplus reserve each period, until this earned surplus reserve reaches one-fourth of their capital. Companies also are required to set aside in a capital surplus reserve funds derived from such sources as the issuance of par value stock at prices above par.[73] Based on these reserve requirements ("earned surplus" and "earned capital surplus reserve"), the Ministry of Justice Ordinance mandates that the capital amounts be divided into statutory reserves (that is, earned surplus reserve and capital surplus reserve) and surplus.[74] The statutory reserves should not be disposed of except to repair deficiencies in capital or as a transfer to capital.[75]

The MOF Ordinance adopts the concept of capital surplus

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[71] MOF Ordinance art. 7.
[72] MOF Ordinance art. 3.
[73] Commercial Code art. 288.
[74] Ministry of Justice Ordinance art. 34.
[75] Commercial Code arts. 289 and 293(3).

prescribed in the Commercial Code,[76] but adds two accounts, one a revaluation reserve in accord with the Assets Revaluation Law[77] and the other titled "other capital reserves," which can be an arbitrary reserve and deemed disposable.[78] The "other capital reserve" account is construed to include voluntary reserves for bad loans from the unappropriated profit surplus for the period. In this sense, the MOF Ordinance provides more leeway for bad loans than provided for in the Ministry of Justice Ordinance.

(3) There are differences in disclosure requirements. Under the Japanese Securities Exchange Law, the disclosure mechanism consists of the registration statement filed with the MOF and the prospectus that summarizes the more detailed registration statement. A registration statement becomes effective on the 30th day after it was filed or on the 30th day after the filing of an amendment, during which period the MOF reviews the statement and determines whether full and fair disclosure has been set forth.[79] When securities are to be sold to the public, the principal protection afforded investors is the disclosure of information through the registration process of the MOF. The functioning and efficacy of this disclosure system depends on the ability of the regulatory agency to examine intelligently the information contained in the registration statement. While the MOF examines regulation statements and subsequent financial information, it does not approve or disapprove of the merits of the business judgments made in such statements. The law requires that sufficient and truthful facts for investor judgment be made available to the public. The ultimate responsibility for adequate and accurate disclosure belongs to the issuer.[80] Even though Japan has its Securities Exchange Law, all companies except limited liability companies are still bound to comply with the requirements of the Commercial Code. Under the Commercial Code, a corporation must publish its articles of association at the time of incorporation and subsequent financial information in the official Gazette or in a daily newspaper.[81] The disclosure requirements under the Commercial Code are insufficient and there is no regulatory public institution like the MOF with which this information can be filed.

Under the Securities Exchange Law of Japan, all financial

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[76] Commercial Code art. 288(2).
[77] Law No. 110 of 1950, Assets Revaluation Law, art. 102 (Japan).
[78] MOF Ordinance art. 63.
[79] Securities Exchange Law art. 8. The effective date may be accelerated by order of the Ministry of Finance if information about the issuer is adequately available for the protection of investors.
[80] Securities Exchange Law arts. 16-18.
[81] Commercial Code art. 166.

statements of issuing companies listed on a securities exchange and filed in accordance with the provisions of the law must be certified by a public accountant.[82] This requirement brought about improvements in auditing practices in Japan, since under the Commercial Code there is no requirement that auditors be independent and professional accountants. The only disqualification contained in the Code is that auditors should not be directors or employees of the company.[83] Under the Commercial Code, auditing was, in practice, a sinecure, often used as a training ground for young executives.

Competent accountants are considered a prerequisite to the effectiveness of the disclosure mechanism. Although in Japan the accounting regulations are sophisticated in their approach, the accounting profession itself is not as well developed as that of England and the U.S.[84] Since the Certified Public Accountants' Law[85] was passed in 1948, this profession has advanced greatly, but to date it has not matched the progress made in the U.S. and England. It has been noted that one of the reasons why Japanese CPAs certify erroneous financial statements is that Japanese CPAs as a profession are too weak to oppose their clients by pointing out inefficiencies and inadequacies of their clients' financial statements.[86]

E. Corporate Tax Laws

Since there were not enough legal and accounting requirements other than GAAP sufficient to regulate the accounting for bad loans either in the Commercial Code or the Securities Exchange Law, the tax law was forced to work as a supplement to these two laws.

There is a specific and detailed rule in Japanese tax law outlining the amount limits that can be reserved for bad debts. The Corporate Tax Law[87] stipulated the following four kinds of limits on loan loss reserves: (1) a method of reserving at a fixed rate for each business type; (2) a reserve method based on the rate of lending losses in the past; (3)

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[82] Securities Exchange Law art. 193(2); Japan, Ministry of Finance Ordinance, *Ministerial Order Concerning the Certified Audit of Financial Statements* No. 12 (1957).

[83] Commercial Code art. 276.

[84] The Seibu Scandal was revealed recently in Japan, which gave all the investors to Japanese companies some doubts as to the Japanese disclosure system. Seibu is one of the leading Japanese listed companies and they disclosed wrong information as to the share holding by affiliated companies for some 40 years, though it was certified by a Japanese CPA. For this scandal, *see* http://www.nikkei.co.jp/sp2/nt85/20041111NN003Y08911112004.html.

[85] Law No. 103 of 1948.

[86] Nihon Keizai Shinbun (Japan Economic Journal), Jan. 12, 1967, at 5.

[87] Law No. 34 enacted on March 31, 1965, *as amended* 46 times thereafter. *Available at* http://www.houko.com/00/01/S40/034.htm.

reserving 50% of the outstanding loans as the fixed outstanding loan depreciation special account when the debtor is banned from bill clearing transactions, applied for protection under the Corporate Reorganization Law[88] or the Bankruptcy Law,[89] or declares the account clearance; and (4) a method of appropriating the reserve amount approved by the director of the governing tax office as a loss when the debtor was incapable of repayment and an asset deficient condition continues for a substantial period.[90]

Since the tax law include specific and detailed rules, a consensus and custom developed to show that it was safe to follow the first of the above-mentioned methods specified in the tax law, i.e., "a method of reserving at a fixed rate." Since the accounting standard lacked detailed regulations, corporations found it necessary to rely on the tax law. The Tax law thus took on a wholly unintended role as a general accounting standard.

Thus, the rules of the Corporate Tax Law played a major role in the accounting practices for loan loss reserves until the calculation of limits for loan loss reserves was fundamentally changed in 1998.[91] The differences between corporate accounting and tax accounting were not recognized until the rule of statutory reserve rates as mentioned in the first method, i.e., appropriating a fixed rate of loan loss reserves, was cancelled by the tax law revision of 1998 (which was to be fully implemented by 2002). The tax law and corporate accounting principles are theoretically different, as the tax law is determined by the Diet in order to pursue various policies from time to time, while corporate accounting is a method of describing a corporation's performance over a fixed period. As the tax rule discussed above indicates, its purpose is to calculate tax liabilities that could not be used as an evaluation standard for loan loss reserves at the closing date. The amount of the loan loss reserves in corporate accounting are estimations on the closing date, so that the credits, less the loan loss reserves, should show the "collectible amount." The tax law does not allow using the estimated amount of the loan loss reserves as the basis of the calculation of tax liabilities.

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[88] Law No. 172 enacted on June 7, 1952, amended on December 13, 2002 (Law No. 154). *See* http://www.ron.gr.jp/law/law/kaishak1.htm.

[89] Law No. 71 enacted on April 25, 1922, amended 11 times thereafter. *See* http://www.houko.com/00/01/T11/071.HTM (htm needs to be in capital letters).

[90] Article 52, *supra* note 87.

[91] Revised on April 1, 1998. *See* Kokuzeicho Tsuutatsu (National Tax Administration Ordinance) (1998) [hereinafter Japanese IRS Ordinance]. For individuals, *see* Japanese IRS Ordinance in Japanese Income Tax Law, available at http://www.nta.go.jp/category/tutatu/kihon/syotok/_01.htm. For corporations, *see* Japanese IRS Ordinance in Japanese Corporate Tax Law, *available at* http://www.nta.go.jp/category/tutatu/kihon/houjin/01.htm.

F. Legal Precedent: The LTCB Case

A precedent-setting court decision has made clear the extent to which Japanese directors are required to follow a flawed accounting method for recording loan loss reserves that can subject them to criminal liability even if they were not intentionally understating loan losses.

The LTCB case was a criminal action concerning the accounting treatment of bad debts. The case was first brought against the former directors of LTCB in October 1999 after LTCB went bankrupt in October 1998.[92] The suit accused three directors, including the former president, of violating the Securities Exchange Law and the Commercial Code. The Tokyo District Court convicted the defendants on September 10, 2002 and in its judgment cited the violation of an MOF notice. The case is currently being appealed. Since this is a leading case in Japan, a detailed analysis is appropriate here.

The facts of the case are as follows: in June 1998, the defendants submitted LTCB's financial statements for the 1997 financial year (April 1997 – March 1998). The statements included a balance sheet, a profit and loss statement, and an appropriation statement indicating an undisposed loss of ¥271,615,000,000 to the Director-General of the Securities Bureau in charge of the Kanto area of the MOF. That amount was substantially smaller than the actual loss of ¥584,684,000,000. The financial statements had not written off or established a reserve that would have indicated that the sum of ¥313,069,000,000 of these loans was estimated to be uncollectible. The act of submitting financial statements with false information regarding such an important item was deemed a violation of Article 197-1 of the Securities Exchange Law.[93]

Moreover, on June 25, 1998, the defendants issued a closing statement to the normal shareholders meeting for its approval that proposed a profit dividend payout of ¥3 per share for a total sum of ¥7,178,647,455. The dividend was to be paid out of the unappropriated reserve account based on the undisposed loss of ¥271,615,000,000. As noted above, however, the actual undisposed loss was in the amount of ¥584,684,000,000 and there was no surplus fund at the closing of that fiscal year. An amount of ¥7,166,002,360 was in fact paid out to the shareholders, thus violating the law requiring certain reserves to be

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[92] RCC v. Onogi, Tokyo District Court, Heisei 11 (Wa) No. 28167, judgment delivered July 18, 2002.

[93] Article 197 provides: "any person falling under any of the following respective items shall be punished by penal servitude for not more than three years, or by fine of not more than three hundred thousand yen... who has, for invitation of subscription or offering-sale, purchase or sale or other transactions of securities, or with the purpose to fluctuate quotations of securities, circulated false rumors, used deceptive schemes, or employed methods of assault and battery of intimidation..."

maintained at certain levels. This act was said to violate Article 489 of the Commercial Code[94] as it was a distribution against Article 290 of the Commercial Code.

Consequently, the defendants were indicted on violations of both the Securities Exchange Law and the Commercial Code. Further background concerning the thinking of the Court is given as follows:

The falsification of securities transaction reports violates Article 197-1 of the Securities Exchange Law which stipulates that "submitting a securities transaction report containing a false statement on a substantial matter" constitutes a crime. The essential element required to be proved is the existence of a "false statement." The procedures to be followed in assembling a securities transaction report are defined in the Ministerial Ordinance Balance Sheet and Profit and Loss Statement.[95] This Ordinance states that a balance sheet, a profit and loss statement, and an appropriation statement (or a loss disposition statement) are all three required to constitute the "accounting status" of the corporation. These documents are to be written in accord with the Rules of Financial Statements and other rules issued with regard to Article 193 of the Securities Exchange Law.[96] According to Article 1-1 of the Rules of Financial Statements, the terms, format, and procedures required in the assembling of the financial statement should be based on these rules, or, if the rules are inadequate, with reference to the "standards of corporation accounting which are generally considered as fair and appropriate."

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[94] Article 489 provides:

The persons mentioned in Article 486 paragraph 1 and inspectors shall be liable to imprisonment with hard labor for a term not exceeding five years or to a fine not exceeding three hundred thousand yen in any of the following cases:

(1) If they have made an untrue statement to or have concealed facts from the Court or the general meeting in respect of the taking up of or payment on all the shares to be issued or of delivery of the property forming the subject-matter of the contribution of property other than money at the time of the incorporation of a company or of any of the particulars mentioned in Article 168 paragraph 1 or Article 280-2 paragraph 1 item (3);

(2) If, for the account of the company, they have wrongfully acquired the shares of a company or have so received them in pledge, irrespective of the name they have used in so acting;

(3) If they have distributed profits or interest, or distributed money under Article 293-5 paragraph 1 in contravention of the provisions of any law or ordinance or of the articles of incorporation;

(4) If, outside the scope of the company's business, they have disposed of the company's property in speculative transactions.

[95] Ministry of Justice Ordinance, No. 31, March 30, 1963.

[96] Article 193 provides: "balance sheets, profit and loss statements, and other documents relating to financial statements to be filed in accordance with the provisions of this Law shall be prepared using such words, manner and method of drawing as prescribed by Ministry of Finance Ordinance according to such standards as generally deemed fair and appropriate by the Minister of Finance."

Since the Rules of Financial Statements, which are based on the Securities Exchange Law, regulate disclosure in only a superficial manner, the essential standards for the accounting procedure for financial statements are to be based on the Commercial Code.[97] Therefore, the accounting disposition of bad loans, the issue in the LTCB case, requires the resolution of questions concerning the application of Article 285-4, Subsection 1 and 2 of the Commercial Code[98] (concerning the evaluation of money claims). The point of contention came down to whether "an amount estimated to be uncollectible had been deducted" with reference to a loan that is "likely to be uncollectible."

However, the Commercial Code does not lay out specific standards useful in deciding whether a loan is "likely to be uncollectible." Nor does it establish standards by which it can be decided whether "an amount estimated to be uncollectible has been deducted." The only source for such standards must be the "fair accounting practices" as stipulated by Article 32-2 of the Commercial Code.[99]

The elements of the second charge, concerning the threat to the financial health of the corporation through the unlawful distribution of assets, were defined according to Article 489-3 of the Commercial Code as "distributing profits or interests in violation of law or the by-laws of corporation" by the directors and others as defined in Article 486-1.[100] The word "law" as used here refers to Article 290-1 of the Commercial Code that pertains to the distribution of profit.[101] Article 290-1 stipulates

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[97] *See* page 15 of the Judgment Document.

[98] Article 285-4 provides:

> the monetary claims shall be valued at the nominal amount thereof; provided that, if they were purchased at the proceeds lower than the nominal amount or there is any reasonable ground, they shall be valued with reasonable decrease.
>
> 2. If there is fear of being impossible to collect the monetary claims, the estimated amount of being impossible to collect shall be deducted in valuation.

[99] Article 32 provides: "every trader shall prepare accounting books and balance sheets for making clear the conditions of business properties and profit and loss."

[100] Article 486 provides: "if promoters, directors, auditors, acting directors or auditors of a "kabushiki-kaisha" as provided for in Article 258 paragraph 2, Article 270 paragraph 1 or Article 280, manager or any other employees commissioned to undertake certain kinds of matters or specified matters relating to the business, have inflicted damage of a proprietary nature on the company in breach of their duties with a view to benefiting themselves or any third person or to damaging the company, they shall be liable to imprisonment with hard labor for a term not exceeding seven years or to a fine not exceeding five hundred thousand yen."

[101] Article 290 provides:

> the distribution of profits may be done to the extent of the amount of the net assets on the balance sheet minus the following amounts:
>
> (1) The amount of stated capital;
> (2) The total sum of the capital surplus reserve and the earned surplus reserve;
> (3) The amount of the earned surplus reserve necessary to be accumulated in the period for the settlement of accounts;

that a "distribution of profit" is allowed up to an amount equal to that which is left over after deducting a certain amount of money from "the net asset amount on the balance sheet." The "the net asset amount on the balance sheet" is a number evaluated in accord with the rules of Article 284-2,[102] the LTCB's loans should also have been evaluated in accord with that article. Thus, the crime of unlawful distribution according to Article 489-3 of the Commercial Code can be seen to be essentially a violation of Article 290 of the Commercial Code, and its applicability to the present case hinged on whether the evaluation of the LTCB's loans violated Article 285-4 of the Commercial Code.

As can be seen from the above discussion, both the crime of falsifying securities transaction reports and the crime of unlawful distribution require proof of whether the defendants failed to "deduct an amount estimated to be uncollectible" with reference to a loan that was "likely to be uncollectible" as defined in Article 285-4, subsection 2 of the Commercial Code in which the basic principles of the evaluation of the money claim concerning the loans in the LTCB's FY98 closing statement are defined. The entire case, in essence, turns on the definition of the phrase, "an amount estimated to be un-collectable when it is likely to be un-collectable."

The Court makes it clear that the standards for judging "an amount likely to be uncollectible" and "an amount estimated to be uncollectible" were to "rely on the fair accounting practices" as stipulated in Article 32-2 of the Commercial Code. According to the judgment, the fair accounting practice that should have been used by LTCB was to have been found in "On the Fund Assessment in a Financial Inspection after the Early Correction System is Implemented (Asset Investigation Notice)" issued by the Minister of Finance. Moreover, this Notice was the only proper accounting standard to be used by financial institutions. Therefore, by deviating from the standards in the Notice, LTCB violated Article 285-4 of the Commercial Code concerning the evaluation of credits. That deviation is consequently, and simultaneously, a "false representation" for the purposes of the Securities Exchange Law and the basis for determining that an illegal distribution of profits had been made in violation of Article 290 of the Commercial Code.

Key to the Court's analysis is the judgment that the Notice issued

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(4) If the total sum of the amounts accounted on the assets side of the balance sheet in accordance with the provisions of Article 286-and Article 286-3 exceeds the total sum of the surplus reserves under the preceding two items, such excess.

[102] Articles 284-2, 285, 285-2, 285-3, 285-4, 285-5, 285-6, and 285-7 make stipulations on "valuations."

by the Minster of Finance was in itself part of the Commercial Code based on the fact that the Notice was issued with regard to Article 32-2 of the Commercial Code.

The Court's judgment on this key point is highly questionable and subject to the following criticisms:

(1) A minister (higher authority) has the jurisdiction to order or instruct an organization under its control (lower authorities) but does not have the power to provide rules directly to citizens regarding their rights or obligations. However, an administrative notice has the power via the Commercial Code through the citation in Article 32-2 of "fair accounting practices." It is incorrect to assume that a notice issued by an authority for the purpose of controlling a specific industry (banking) can also act as a law (Commercial Code) to control corporations in other industries.

(2) The Asset Investigation Notice issued by the Minister of Finance, who has supervisory authority over banks, is intended to provide guidance for "the calculation of the net worth ratios of financial institutions," and is not intended to "clarify the managerial responsibility of directors by means of disclosing the financial status or operational performances of a corporation from the standpoint of protecting the benefits of the corporation's creditors or shareholders."[103] It should be clear that the notice can only be used as the basis for the Minister of Finance to take actions based on the Banking Law against a bank for violations of the notice. Given this narrow purpose of the notice, it seems difficult to imagine that a violation of it can be seen as a violation of the Commercial Code via Article 32-2.

(3) The legality of treating a violation of a notice or an administrative guidance order as criminally punishable is also problematic. The demand for rigorousness in the evaluation of assets is necessary for the sound financial administration of the banking sector. In order to make a violation of an administrative notice criminally punishable, an accounting standard must already be provided in express terms in the law. The creation of a crime based on an unclear accounting standard is highly problematic. With regard to the LTCB case, it would seem that the defendants were punished because of the absence of an express law in Japan regarding "fair accounting practices" rather than because they willfully understated assets.

The legality principle is guaranteed through parliamentary legislation and is encapsulated in slogans such as "the nation can recognize crimes and punishments only within the law," "actions that can

[103] *See* page 47 of the Judgment Document.

be punished are limited to those recognized by the law as crimes," and "means of punishment are also defined by the law." Moreover, the Constitution of Japan[104] guarantees the legality principle by stating that "no person shall be deprived of life or liberty, nor shall any other criminal penalty be imposed, except according to procedures established by law."[105]

The legality principle includes the statutory law principle, that states that a law must be expressed in a form of "black letter law," that is, sentences established and promulgated through a specified process. Therefore, a criminal law must also be expressed in the form of sentences. The trend in the UK and the USA is to lean toward the abolition of common law crimes. In Japan, the Japanese Constitution states that a criminal law must be a "statutory law."[106]

Since it is difficult to enact all the laws required to cover all the situations that can occur in society, the administrative branches of the government are empowered to generate "orders." Without the establishment of strict controls over the right to issue such orders, the statutory law principle would become meaningless. The Japanese Constitution stipulates that an order can define a crime only when the law authorizes a particular branch of the government the right to do so in specified areas of the law.[107] These days it is common, for example, for a law to be written so as to define the statutory categorization of crimes and punishments, while orders are issued to define both crimes and punishments more specifically within the given statutory structure. As compared to orders, ordinances are supposed to be subordinate, so that any ordinance that contradicts an order is invalid. As compared to ordinances, notices are further subordinate. If criminal punishments must be based on statutory law, and orders and ordinances are subordinate to and their scope restricted by statutory law, then it seems troublesome to punish someone based on a mere notice.

A citizen has the right to know the law. Therefore, it stands to reason that the principle that "ignorance of laws is no excuse" has been accepted as reasonable. Of course it is at times extremely difficult for a citizen to understand that his/her action is punishable because of the sheer plethora of rules in the criminal law. The Criminal Law of Japan[108] insists that "[i]gnorance of the law does not prove that a person did not have a will to commit a crime. However, the punishment for such an act

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[104] Enacted November 3, 1946.
[105] Article 31.
[106] *Id.*
[107] Article 73.
[108] Law No. 45, enacted on April 24, 1907.

can be lessened considering the circumstances."[109] In the accounting law arena, this provision means that, although an act is punishable based on a government notice, the awareness of the Asset Investigation Notice will be taken into account in the sentencing of the defendant.

The real problem in this case is that this Notice defines the constitutional requirements. As mentioned above, the Constitution states that a criminal punishment must not contradict the legality principle. According to the legality principle, the elements of a crime have to be defined in accordance with the law in order to punish a person for committing the particular crime.[110] The clarity principle of criminal law is a derivative of the legality principle.

(1) What is meant by the clarity principle is that it is an essential component of legality that exactly what is and is not a crime must be made explicit. Note that notices, unlike statutes, are not made public to citizens in general. Citizens therefore cannot know the contents in advance or change their behavior in reaction to it.

While it is true that banks receive examination notices directly, there is another difficulty because such notices are not generated in accord with the proper legal procedures that can make them legally effective. For example, it is unclear when a notice becomes effective. While the period of validity of a given statute is clearly stated in official gazettes, a notice gives no indication of its effective date and could be considered effective perhaps on the day it was issued, the day when a person comes to know of it, or the day specified in the notice. Finally, while the Notice in this case requires the use of "a fair accounting practice," it fails to specify a "practice" begins to be regarded "practice" for the purposes of the statute.

(2) Another essential component of the legality principle is that the scope of punishment must be clearly indicated in advance. In the LTCB case, the Asset Investigation Notice was issued by the Minister of Finance and appears to be intended to elucidate the calculation of the equity ratio for a particular bank. The Court states that the Asset Investigation Notice was "the only rational standard concerning depreciation/reserve allowances for lending by financial institutions"[111] However, it remains unclear as to whether this Notice applies only to banks under the Commercial Code or if it is applicable to all corporations. Since the Court declared that the case involves a violation of the Commercial Code, and since the accounting for nonperforming loans is to

[109] Article 38.
[110] Articles 31 and 39.
[111] Document of the Judgment, p. 42.

be determined based on Article 285-4 of the Commercial Code, we could surmise that the contents of the Notice should be applied to all corporations. Yet prior to the Court's judgment, it is certainly true that the scope of the Notice's application was unclear and is therefore problematic as a ground for criminal punishment.

(3) The Asset Investigation Notice became in this case the ground for criminal punishment. According to the Constitution, a government ordinance cannot form the basis of criminal punishment unless the government agency is given the requisite authority by law.[112] Note that the claim in this case insists that there has been a violation of Article 285-4 of the Commercial Code and, therefore, that the criminal punishment is not directly based on the Notice. However, the Asset Investigation Notice in this case corresponds, practically speaking, to the contents of Article 285-4 of the Commercial Code via Article 32-2 of the Commercial Code.

According to the Court, the Asset Investigation Notice is regarded as a part of the substance of the Commercial Code because it can be "considered" a "fair accounting practice" according to Article 32-2 of the Commercial Code. However, the Notice cannot be part of the substance of the Commercial Code by simply being considered a "fair accounting practice." Note that although Article 32-2 of the Commercial Code obligates a company to "consider" a "fair accounting practice," the company is in fact free not to adopt a practice after giving it due consideration. It is unclear how best to interpret the request to "consider" something when a notice is being used as a ground for a criminal punishment. Indeed, the terminology of "consider" is rarely used in criminal law due to its ambiguity (though "consider" is used in many circumstances in the Civil and Commercial Codes). Thus the directive to "consider" used in the Notice, even as an indirect basis for criminal liability, is highly problematic.

(4) The Court makes the statement that "the Asset Investigation Notice was the 'only' rational standard concerning depreciation/reserve allowances for lending by financial institutions."[113] This statement shows that the Court relied on the Notice as the main ground for establishing criminal liability. Moreover, the statement also shows that the Court recognized that it had to insist that the accounting standard indicated by the Notice was the sole accounting standard available to LTCB. After all, if there were other possible standards available, which themselves had the status of fair accounting practices,

[112] Article 73.

[113] Document of the Judgment p. 42.

then it would be difficult to label a departure from the terms of the Notice as a violation much less a crime.

Yet it is common knowledge that there is more than one accounting standard for the treatment of bad debt; in fact, there are several possible accounting standards. As long as the accounting standard actually used can be considered an acceptable accounting standard, then its use cannot be considered a violation. In the LTCB case, the defense explained that the auditors had produced an opinion regarding the treatment of bad debt and had pronounced the procedure appropriate in light of the GAAP. If that is the case, then even if LTCB deviated from the terms of the Notice, the accounting procedure they used cannot be considered anything but proper.

In sum, as to the illegality of an accounting procedure, it is difficult to see how LTCB deserves a criminal charge just because it violated a notice setting out one of the many possible fair accounting practices. The real problem, and one that cannot be cured by the banks, is that there is no specific rule concerning the handling of bad loans in the "corporate accounting principles" based on the Commercial Code.

V. U.S. ACCOUNTING REGULATIONS ON BAD LOANS

It is clear from recent experience (e.g. Enron and Arthur Anderson) that the U.S. situation is far from perfect. However, knowing what practices and regulations are currently used in the U.S. is important to show how Japan differs from them.

A. The Securities Exchange Laws

The Securities and Exchange Commission ("SEC") relies on an independent, private sector to develop standards in a process that is thorough, open, and deliberate. While the SEC has the statutory authority to establish accounting principles, it looks to the private sector for leadership in establishing and improving accounting standards. [114] Therefore, the quality of U.S. accounting standards may be attributed in large part to the practical experience of the private sector as overseen by the SEC.

The organization responsible for reviewing and rationalizing these standards derived from the private sector standards is the Financial

[114] ACCOUNTING SERIES RELEASE (ASR) No. 4 (April 1938) and ASR No. 150 (December 1972). *See also* SEC CODIFICATION OF FINANCIAL REPORTING POLICIES § 101; Garrett, The Accounting Profession and Accounting Principles, Address Before Second Annual Robert M. Trueblood Memorial Conference, Ill. C.P.A. Foundation (Oct. 3, 1975).

Accounting Standards Board ("FASB"), which was established in 1972. The FASB's standards form the black letter "generally accepted accounting principles." The FASB's standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

The accounting principles relating to the accounting treatment of bad debts are contained in Statement of Financial Accounting Standards ("FAS") No. 5, "Accounting for Contingencies"[115] and FAS No. 15, "Accounting for Debtors and Creditors for Troubled Debt Restructurings,"[116] issued by the FASB. These standards determine the timing and adequacy of specific provisions. Specifically, an estimated loss is accrued by a charge to income if it is expected that an asset has been impaired or a liability has been incurred and if the amount of the loss can be reasonably estimated. The standards go further with regard to impaired assets and loans. Impaired loans are to be measured based upon the present realizable cash value.[117] The present realizable cash value is defined as the present value of expected cash flows discounted at the loan's effective interest rate.[118]

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[115] ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975) is summarized as follows:

> This Statement establishes standards of financial accounting and reporting for loss contingencies. It requires accrual by a charge to income (and disclosure) for an estimated loss from a loss contingency if two conditions are met: (a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and (b) the amount of loss can be reasonably estimated.

Available at http://www.fasb.org/st/summary/stsum5.shtml.

[116] ACCOUNTING FOR DEBTORS AND CREDITORS FOR TROUBLED DEBT RESTRUCTURINGS, Statement of Financial Accounting Standards No. 15 (Financial Accounting Standards Bd. 1977) is summarized as follows:

> This Statement establishes standards of financial accounting and reporting by the debtor and by the creditor for a troubled debt restructuring. This Statement requires adjustments in payment terms from a troubled debt restructuring generally to be considered adjustments of the yield (effective interest rate) of the loan. So long as the aggregate payments (both principal and interest) to be received by the creditor are not less than the creditor's carrying amount of the loan, the creditor recognizes no loss, only a lower yield over the term of the restructured debt. Similarly, the debtor recognizes no gain unless the aggregate future payments (including amounts contingently payable) are less than the debtor's recorded liability.

Available at http://www.fasb.org/pdf/fas15.pdf.

[117] *See* RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, Accounting Research Bulletin No. 43 (1953) (replaced ARB's issued September 1939-January 1953), Chapter 3A-9. It stipulates:

> The amounts at which various current assets are carried do not always represent their present realizable cash values. Accounts receivable net of allowances for uncollectible accounts, and for unearned discounts where unearned discounts are considered, are effectively stated at the amount of cash estimated as realizable.

[118] ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN, Statement of Financial Accounting

B. Corporate Tax Laws

The purpose of the corporate tax laws is to shelter a portion of the bank's current earnings from taxes to help the bank create a reserve to mitigate the effect of bad loans. The amount of losses from bad debts is deducted annually from current revenues before taxes.

Prior to the passage of the Tax Reform Act of 1986,[119] all U.S. banks calculated their deductions for losses from bad debts using either:

(1) the "experience method" (in which the amount of deductible bad debt expense is defined as the product of the average ratio of net loan charges to total loans in the most recent six years times the current total of outstanding loans), or

(2) the "reserve method" (which allows banks to deduct automatically, without being taxed, up to 0.6 percent of their eligible loans at year-end).

U.S. banks could choose between these two different expensing methods based on which one results in the greatest tax savings.

The Tax Reform Act of 1986 requires large U.S. banks and bank holding companies to use the "specific charge-off method," which allows them to add, out of pretax income, no more than the amount of those loans actually written off as uncollectible to loan-loss reserves each year. The expensing of a worthless loan usually occurs during the year that the loan becomes worthless. Small banks and banking companies (under

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Standards No. 114 (Financial Accounting Standards Bd. 1993) states:

> It requires that impaired loans that are within the scope of this Statement be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral dependent. This statement amends FASB Statement No. 5, *Accounting for Contingencies*, to clarify that a creditor should evaluate the collectibility of both contractual interests and contractual principle of all receivables when assessing the need for a loss accrual. This Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Trouble Debt Restructurings*, to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with this Statement.

ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN-INCOME RECOGNITION AND DISCLOSURES, Statement of Financial Accounting Standards No. 118 (Financial Accounting Standards Bd. 1994) states:

> This Statement does not change the provisions in Statement 114 that require a creditor to measure impairment. This Statement amends the disclosure requirements in Statement 114 to require information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.

[119] *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

$500 million in assets) were authorized to continue using the experience method or to switch to the specific charge-off method as they determined best reduced their taxes.

C. *Legal Precedent: Civil Liability*

In a case in 2001,[120] the Court concluded that the plaintiff adequately set forth the necessary *prima facie* case for negligent misrepresentation, based on the allegations set forth in the complaint. The complaint alleged that, "the individual defendants knew, based upon their business sophistication, experience, and knowledge of accounting, that Boston Chicken's (the lender) financial statements were false and misleading." The plaintiff further alleged that a loan loss reserve was required, but was not taken against the substantial loans made to FAD (the borrower) because the loans were impaired; the Boston Chicken's reported revenues, being largely the result of loans made to FAD and recycled back to Boston Chicken, were fictitious. The complaint also alleged that the individual defendants knew that the financial statements audited by Arthur Andersen were false and misleading. Apparently, these false and misleading financial statements enabled Boston Chicken to raise hundreds of millions of dollars of debt and equity capital from the investing public.

Many cases in the U.S. turn on the claim that the misuse of accounting for loan loss reserves are material misstatements and that statements characterizing a loan loss reserve as "soundly underwritten" are actionable.[121]

D. *Legal Precedent: Criminal Liability*

In a case in 2002,[122] the Court held that the defendant kept its loan loss reserve artificially low. Regarding the financial statements of ASB Bank, the Court said:

Like other banks, ASB had a loan loss reserve to cover all

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[120] Gerald K. Smith v. Anderson L.L.P., 175 F. Supp. 2d 1180 (Ariz. 2001).

[121] Shapiro v. UJB Financial Corp., 964 F.2d 272 (3rd Cir. 1991), *cert. denied*, 121 L. Ed. 2d 278, 113 S. Ct. 365 (1992) (holding that statements characterizing loan loss reserve as "adequate," describing the loan portfolio as "well collateralized" and of high "quality," and praising internal controls as properly centralized, supervised, and managed, could state a claim); Mayer v. Mylod, 988 F.2d 635 (6th Cir. 1993) (holding that statements characterizing the loan portfolio as "soundly underwritten" were actionable along with allegations of misrepresentation concerning non-performing assets and inadequate loan loss reserves).

[122] United States of America v. Ralph H. Whitmore, Jr., 35 Fed. Appx. 307 (9th Cir. 2002).

losses in its loan portfolios as well as other potential losses. If the loan loss reserve was understated for any given period, ASB's income would be overstated, as it would not accurately reflect the bank's true assets. At ASB, Whitmore (the defendant) had the sole responsibility for determining the loan loss reserve and had no formal method of making this determination.

In 1987, Whitmore kept the loan loss reserve artificially low in ASB's reports so as to mask the financial difficulties the bank was facing. Despite opposition from ASB officers who refused to sign such falsified financial forms, Whitmore's loan loss reserve calculations for 1987 misstated the true financial status of ASB.

VI. RECOMMENDATIONS FOR JAPAN

In October 2002, the FSA revealed its policy regarding the bad debt burdens faced by the banks in a paper titled, "Program for Financial Revival: Revival of the Japanese Economy Through Resolving Non-Performing Loans Problems of Major Banks."[123] In other words, the FSA made it clear that it intends to review the accounting standards regarding asset evaluation in order to tighten controls on the asset evaluation practices of financial institutions.

According to the paper, the FSA will insist upon consistency in the asset evaluation standard based on the market value. With reference to loan loss reserves, the agency says it will apply the American style DCF (discount cash flow) technique.[124] In particular, it intends to use the individual reserve method based on the DCF technique concerning large borrowers already listed on the warning lists of major banks. In order to implement the DCF method, the FSA revised its financial inspection manual and asked major lenders to use it beginning in FY2003. Unfortunately, little is yet known as to its specificity of the manual's contents and the processes it involves.

In my opinion, the appropriate accounting method for estimating bad debt reserves should indeed be the DCF method of asset evaluation. Indeed, the DCF method should be adopted as a clear and explicit rule of asset evaluation in every circumstance. Even despite its admitted

[123] FSA, Program for Financial Revival: Revival of the Japanese Economy Through Resolving Non-Performing Loans Problems of Major Banks 1, *available at* http://www.fsa.go.jp/news/newse/e20021030.pdf.

[124] For DCF *see* Ross, Westerfield and Jaffe, CORPORATE FINANCE, 7th ed. (2005).

difficulties, it is still far better than a reliance on traditional practices or some other loose notion of "fair and reasonable." At the very least, the DCF calculation can be recreated and its assumptions laid bare to critical reevaluation. While it is difficult as yet to judge how the DCF method will be fare in Japan and if it will meets the goals of the FSA, there is no doubt that the FSA is intending that financial institutions must begin using the method.

DCF is a quantitative measurement technique intended to address the problem of chronically insufficient reserves such that bad debts cannot be adequately covered. The goal is to force the banks to engage in more accurate market value evaluations as well as to force them to allocate more funds to their bad debt reserves in order to fill the gap between book values and market values. DCF is an aggressive banking policy; indeed, such an aggressive policy issued by the Japanese government is almost unheard of.

The DCF technique boils down to the prediction of future cash flows discounted to present value. The difficulty that must be overcome is how to select an appropriate discount rate reflecting the risk premium. In the case of a bad loan with a risk of default, it is necessary to estimate the credit risk. It is not enough to calculate just the estimated default probability. It is necessary to use a discount rate obtained by applying the risk premium in addition to the market interest rate. In dealing with a corporation with an especially high borrowing interest rate, it may be necessary to use a higher risk premium. Even a small change in the discount ratio will cause DCF results tend to change substantially. If a low interest rate is used as a discount rate, it can result in a mistaken overvaluation of the loan. Certainly the DCF method had its benefits, yet even a small miscalculation in the discount ratio can result in highly misleading results.

The following example illustrates the differences between the traditional accounting methods used before 2002 and the proposed DCF method:

Suppose a bank loans $10,000 for a 5 year term at 5% interest rate. Suppose further that the borrower's repayments (principal plus interest) are expected to decline due to poor business management as shown in Table 3.

Under the traditional method, the bank would reserve only 5% of the loan amount ($500) against possible losses. This practice would be regarded as fair and reasonable based upon past experience. Based upon the DCF method, however, the net present value ("NPV")[125] of the loan

[125] The Net present value (NPV) of an asset is equal to the present value of its annual after tax net

amounts to only $8150.98 due to poor future cash flows occurring between the 2nd to 5th years. Reflecting this deteriorating NPV, the DCF method would indicate that the bank should reserve $1175.25 (=10,000 – 8150.95) against possible loss. This number amounts to 11.75% of the total loan amount.

The DCF method is more prudent and indicates with precision exactly how much to reserve against possible future losses based upon future estimated cash flows. Using this more prudent method would result in larger reserves and fewer bank collapses due to bad loans.

Table 3: NPV of the Loan

	Scheduled Payment (Principal + Interest)	Estimated Payment and Present Value Factor (Principal + Interest)
Year 1	2309.74	2309.74 x 0.9524 = 2,199.80
2	"	2000.00 x 0.9070 = 1,814.00
3	"	1800.00 x 0.8638 = 1,554.84
4	"	1700.00 x 0.8277 = 1,407.09
5	"	1500.00 x 0.7835 = 1,175.25
		NPV = 8,150.98

VII. THE APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS IN JAPAN

It is clearly due to the fact that the Japanese accounting system incorporates standards different from international standards that so many problems, including those related to the accounting for bad debts, are produced in Japan. These national accounting standards remain different

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cash flows less the investment's initial outlay. The net present value can be expressed as follows:

$$NPV = \sum_{t=1}^{n} \frac{ACF_t}{(1+k)^t} - IO$$

where ACF_t = the annual after-tax cash flow in time period t

k = the appropriate discount rate

IO = the initial cash outlay

n= the project's expected life

The asset's net present value gives a measurement of the net value of the asset in terms of today's dollars. Because all cash flows are discounted back to the present, comparing the difference between the present value of the annual cash flows and the investment outlay is appropriate. The difference between the present value of the annual cash flows and the initial outlay determines the net value of the asset in terms of today's dollars.

despite the fact that Japanese corporations are becoming increasingly international in their outlook. It has been long felt that there was a need for international standardization so that investors can understand and properly compare the performances of corporations of other countries when they seek financing overseas. It is only recently, however, that accounting standards more international in scope have been gradually taking shape.

The U.S. Financial Accounting Standards Boards ("FASB") and the International Accounting Standards Board ("IASB")[126] held a meeting in September 2002 and there reached an agreement called the Norfolk Agreement. The Agreement seeks to encourage a convergence between the International Financial Reporting Standards ("IFRS")[127] and the U.S. standards and further lays the foundation for increased convergence among various national accounting standards.[128] The IFRS standards are to be adopted officially in 2005 as the financial reporting standards for publicly traded corporations in the EU. It seems that Japan is likely also going to approve the requirement that financial statements should be prepared according to the IFRS. Nevertheless, the issue is not without contention. Opinions have issued from both government and private sectors concerning the desirability of adopting the IFRS in Japan and no consensus has yet been reached.

A. Opinions of the Government

Japanese corporations typically generate two sets of financial statements in accordance with two laws, i.e., the Commercial Code and the Securities Exchange Law. With the adoption of the IFRS, corporations would be freed from the burden of preparing these two sets of financial statements. Unsurprisingly, both the Ministry of Justice, which has jurisdiction over the Commercial Code, and the FSA, which has jurisdiction over the Securities Exchange Law, object to the adoption

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[126] In June 1973, the International Accounting Standards Committee was established by joint efforts of 10 countries, including the USA, Japan, England, France, and Germany. This committee was reorganized as IASB in April 2001.

[127] IFRS is a collective name for accounting standards established by the International Accounting Standards Board ("IASB") with a purpose of being approved and observed internationally. A part of the IFRS include International Accounting Standards ("IAS").

[128] In October 2002, SEC chairman Harry C. Pitt applauded the decisions by the FASB and IASB to work together toward greater convergence between U.S. Generally Accepted Accounting Principles and international accounting standards. He said "This is a positive step for investors in the U.S. and around the world. It means that reducing the differences in two widely used sets of accounting standards will receive consideration by both boards, as they work to improve accounting principles and address issues in financial reporting." *See* http://www.sec.gov/news/press/2002-154.htm.

of the IFRS. The differences between the Japanese Commercial Code and the IFRS are as shown in Table 4.

Table 4: Major Differences between Financial Documents/Consolidated Financial Documents of Japanese Commercial Code and the IFRS

Japanese Commercial Code	International Standards	Major Differences
(1) System: - Balance Sheet - Earning Statement - Profit Appropriation Plan - Supplemental Statement	(1) System: - Balance Sheet - Earning Statement - Shareholder's Share Variation Statement - Cash Flow Statement - Descriptive Annotation	The Japanese Commercial Code lacks basic financial tables such as the Shareholder's Share Variation Statement and the Cash Flow Statement. Annotation is also limited. The Profit Appropriation Plan is not included in IFRS standards. The Supplemental Statement, as defined in Art. 281, Sec. 1 of the Japanese Commercial Code is not a disclosing document so it is not disclosed to shareholders. No such concept as the Supplementary Statement exists in IFRS.
(2) Disclosed documents (of large corporations): - Individual Statements - Consolidated Statement	(2) Disclosed documents: Consolidated Statement only if subsidiaries exist; Individual Statement only if no subsidiary exists	Under the IFRS, only one financial statement is required to be disclosed; in other words, consolidated statement only is disclosed if subsidiaries exist.
(3) Single year statements only.	(3) Comparative multiyear financial statements.	The IFRS require the disclosure of financial statements that make explicit comparisons with the

		statements disclosed in previous years. Single year statements are not required by IFRS.
(4) Annotation is limited.	(4) Annotation is an important part of financial statements.	Annotations in the IFRS are expected to be a rich source of disclosure.

As a reason for its objection, the FSA states that "it is not accepted as a practice even in the United States to apply the International Accounting Standards to both domestic and foreign corporations as fair and appropriate accounting standards."[129] However, it would be more accurate to say that the SEC does in fact allow the use of foreign accounting standards, including International Accounting Standards, as long as the corporation also files a U.S. GAAP reconciliation statement,[130] in order to describe the differences between the U.S. and the international standards being used. For example, Bayer, a German pharmaceutical company, filed its financial statements prepared in accordance with the International Accounting Standards on Form 20-F for the SEC in order to be traded on the New York Stock Exchange. Many foreign corporations engage in this practice. The New York Stock Exchange welcomes foreign corporations to be traded there and approves the use of the International Accounting Standards.

The Counselor for the FSA has himself spoken about his opinion about the adoption of the IFRS during the General Assembly of the Business Accounting Council held on December 6, 2002:[131]

> In a sense, I myself have a certain level of awareness that it is probably necessary to have 'restraint' against 'excessive inclination' toward the IFRS. I also think it is very important to grasp the situation accurately, to make sure that discussion is based on balanced thoughts, and what kind of measures are available to guarantee such a balance. Of course I understand that the IASB has no enforcing power. I think we would most

[129] A record of the Designated Structural Reform District Promotion Office of the Prime Minister's Office dated May 9, 2003. *See* http://www.kantei.go.jp/jp/singi/kouzou/kouhyou/021022/kaitou03.pdf.

[130] An example is available at http://www.sasol.com/sasol_internet/downloads/US%20GAAP%20Reconciliation_1048162888717.pdf.

[131] "Direct Investment in Japan," reference data, Cabinet Office.

likely adjust our thoughts to theirs as to what degree and in what areas based on the standpoint of cost vs. benefit. In other words, I think it is like putting the cart before the horse if the actual state of economy or industry is interpreted differently depending on which accounting principle is to be used. Therefore, I believe it is necessary to approach the issue from the standpoints of what kind of 'check' is needed on the IASB discussions or how we should lead the discussions reflecting the actual economic states of our country or how to achieve a more appropriate unbiased system.

On March 3, 2003, Mark Norbom (president & CEO, GE Japan Ltd.), spoke at the 25th Japan Investment Council's meeting held under the auspices of the government of Japan. Mr. Norbom expressed his opinion concerning the introduction of the IFRS and was responded to by the FSA as follows:

Counsel Norbom: Introduction of the International Accounting Standards should be accelerated.

FSA: As to the disclosures of financial statements based on the IFRS, we will judge them case by case and treat them based on the agreement at the IOSCO.[132] We will also be watching closely the discussions made on the Financial Accounting Standards Committee.[133]

[132] The International Organization of Securities Commission ("IOSCO") was established in 1988 under the auspices of the authorities (who regulate securities markets) of various countries, such as the Ministry of Finance of Japan and the SEC in the U.S., in correspondence with the extreme expansions of corporations seeking funding in overseas markets. It established principles to achieve three objectives: (1) protection of investors; (2) increase of transparency of markets for fair and efficient transactions; and (3) minimize systemic risks. IOSCO is a member of the International Accounting Standards Committee (IASC) and does not have its own accounting standards.

[133] A committee established by investments of ten organizations including the Japan Federation of Economic Organizations, Japanese Institute of Public Accountants, National Securities Exchange Conference, Japan Securities Dealers Association, Japanese Bankers Association, Life Insurance Association of Japan, General Insurance Association of Japan, and Japan Chamber of Commerce and Industry for the establishment of accounting standards using the U.S. FASB as a model. It is notable that the government did not invest in it.

B. *Opinions of the Private Sector*

The Japan Federation of Economic Organizations ("Keidanren")[134] is also taking a negative position at this point in time.[135] On July 22, 2003, the Chairman of the IASB, Sir David Tweedie, visited Keidanren and stated:

> The purpose of ISAB is to establish a uniform high quality accounting standard that can be used in all markets of the world. On account of the fact that people lost trust in accounting practices in various countries of the world through the experiences of unfortunate incidents exemplified by the Enron incident in the U.S. and the financial crises of Asian countries, it is strongly desired to establish an international uniform accounting standard. We dearly wish Japan's cooperation in this regard.

To this plea, Keidanren responded by saying:

> We have yet to see the evidence that any evaluation has been made of the opinion we submitted to the ISAB concerning the draft of the accounting standards and any reasons why our opinion was not adopted. Thus, we would like to see an improvement on the evaluation procedure. We believe that the ISAB's thought is too biased and we wish the ISAB to conduct discussion with more considerations on the realities of practical business matters.

C. *Opinions of Journalists*

Nihon Keizai Shimbun[136] has reported on the situation in an article titled "Haphazard Accounting Reforms" in which it was claimed that corporate accountants have lost their self-confidence and the trust of

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[134] Keidanren is a general economic organization consisting of 1,623 companies and other organizations, which include 91 companies with foreign capital affiliations and 1,306 major representative Japanese companies. It is the strongest interest group in Japan that applies pressure on the government as well as overseas organizations collecting opinions from all corners of business communities on any important issues of business communities ranging from economic and industrial issues to labor issues urging speedy solutions. For details, *see* http://www.keidanren.or.jp/indexj.html.

[135] Refer to its announcement dated April 20, 2004, *available at* http://www.keidanren.or.jp/japanese/policy/2004/032.html.

[136] Nihon Keizai Shinbun, November 12, 1999.

others since they face the prejudice that "Japanese disclosures are not reliable." The article was in favor of the adoption of the IFRS and stated:

> The entire Japanese accounting system is scrutinized with doubting eyes. The rating [of companies] is a very important indicator. [Companies] must lower their funding costs by raising their credibility. As the direction of the reform of the accounting system is unclear, companies have to improvise in order to defend their ratings. One viable alternative is to switch entirely to the international accounting standards rather than waiting for a national reform of the accounting system. At this moment, 28 companies have self-defensively switched to the U.S. accounting standards and eight companies (one duplicated) are adopting the International Accounting Standards to distance themselves from the suspicions of the Japanese accounting system. The establishment of the International Accounting Standards is a form of self-defense for Japanese companies.

VIII. CONCLUSION

It is clearly important for Japanese financial institutions to appropriate the necessary minimum reserves against loan losses through a more stringent evaluation of bad loan risks. Additionally, Japanese banks must improve their shortcomings in their reporting procedures to regain their international credibility.

The bad loans problem continues to cause great debate throughout Japan. The use of taxpayers' money to bail out private enterprises has been particularly contentious. Politicians, government officials, banks, and taxpayers have all expressed their own opinions as is necessary before a national consensus can be achieved. This discussion is both unique and momentous in the history of Japanese politics and economics. The debate has covered everything from the very simple and popular sentiment that "not even a single yen of tax should be used" to highly theoretical analyses of lenders' liability, stockholders' representative actions, and directors' responsibility. No matter what the end resolution may be, the fact that a wide spectrum of citizens have participated can be considered desirable in itself.

Bad loans are of course not limited to banks, but can occur accidentally in any business operation. Therefore, there is a need to have a clear-cut standard for loan loss reserves for all corporations. As yet, there is no clear-cut accounting standard for such a thing in Japan. The

question of how to identify the real status of bad loans and how to handle them is capable of being reduced to a question of appropriate accounting standards.

The phenomenon in Japan whereby banks would make profits and distribute dividends only to go bankrupt within six months, as in the case of NCB and LTCB, would have been impossible if the accounting standards of the U.S. had been used. In the U.S., an accounting auditor has access to clear and explicit statements of standards against which financial statements can be compared. In Japan, in contrast, not only were the accounting methods themselves flawed, but the situation was further confused by a dual mandatory disclosure system imposed by the Commercial Code and the Securities Exchange Law. Japanese banks faced unclear and loose regulations and standards. Despite their recognition of the problems, the banks and the regulators, such as the MOF, continued to ignore the resulting inaccuracies and insufficiencies. The Courts themselves appear to be confused about the situation in that, in the LTCB case, unclear accounting standards formed the basis of a criminal charge of violations of the Commercial Code.

In order to restore the trust in the Japanese financial sector and to rebuild the financial markets, the bad loan burdens on the banks must be resolved first. This first step is necessary to the establishment of a more solid financial system in which the bad loan ratios of major banks are lowered, related problems are fixed, and the overall restructuring of socio-economic system is supported. To do so, major banks must be forced to make more stringent evaluations of their assets, enrich their own capital, and strengthening of their corporate governance. Above all, the banks must be forced to appropriate necessary minimum reserves against loan losses through the more stringent evaluation of bad loan risks. As of yet, as this article has pointed out, the various rules and regulations governing the accounting treatment of loan loss reserves in Japan are still far behind those used in the United States.

Indeed, it is not just the accounting treatment of loan loss reserves but the entire set of accounting standards that must be reviewed and revamped in Japan. There is a marked difference between the United States and Japan regarding strictness in the pursuit of disclosure duties of corporations. It is safe to say that an average Japanese company, including banks, has not felt the need to disclose important information in a timely fashion. Japanese banks must observe the disclosure principle more stringently and get into the habit of disclosing pertinent operating information to stakeholders, such as stockholders and corporate customers, earlier, more quickly, more frequently, and more thoroughly. The more thoroughly Japanese banks conduct disclosure, the higher their

market evaluations will be. By assuming full and strict responsibility of management and supervision, they will be able to regain the trust of the international securities market.

In light of these points, it would seem eminently correct to require a change in accounting standards more in line with the international standards promoted by the IASB. Japanese accounting standards were of course not built overnight but are rooted in a long history and are deeply entangled with other regulations. Cultural differences are also a factor. In order to adopt the International Accounting Standards, reviews of other related laws such as the Commercial Code, the Securities Exchange Law and the Tax Law would become necessary. Consequentially, a quick adoption of the international standards is unlikely to occur. It will most likely occur rather slowly; however, what is certain is that it is an essential step in the inevitable process of the total internationalization of the Japanese economic system.