

The Present Policy on the Application of International
Financial Reporting Standards (IFRS)

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Business Accounting Council

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1. Preface

The Business Accounting Council has deliberated on various matters related to International Financial Reporting Standards (IFRS).

On June 30, 2009, the Council published “Interim Report: Opinion on the Application of International Financial Reporting Standards (IFRS) in Japan,” presenting ideas on voluntary application of IFRS and considerations for future mandatory application. Necessary steps have been taken in accordance with this interim report, e.g. Japanese companies that satisfy certain requirements were given the option to prepare their consolidated financial statements, starting from the consolidated fiscal years ending on or after March 31, 2010, by applying IFRS.

In addition, the Business Accounting Council deliberated on IFRS for about one year from June 2011 and published “Previous Discussion Summary for the Consideration on the Application of IFRS in Japan” in July 2012. In this summary, the Council recommended that consideration should be given to the most suitable way for Japan to respond to IFRS while building up the examples of voluntary application of IFRS as well as paying due attention to the purpose of the application of IFRS and its impact on the Japanese economy and systems, based on the premise that the accounting standards for consolidated- and non-consolidated (single-entity) financial statements could be different.

Based on this summary, the Business Accounting Council continued deliberations on IFRS. During this period, the U.S. Securities and Exchange Commission (SEC) published its final staff report in July 2012, but it did not refer to a specific direction or schedule for the application of IFRS. Furthermore, in March 2013, the IFRS Foundation Monitoring Board issued a press release that clarified the definition of the “use of IFRS,” a

membership criterion of the IFRS Foundation Monitoring Board. In April 2013, as the new framework of cooperation between the International Accounting Standards Board (IASB) and national accounting standard-setters and regional bodies involved with accounting standard-setting (regional bodies), the Accounting Standards Advisory Forum (ASAF), which consists of 12 national accounting standard-setters and regional bodies including the Accounting Standards Board of Japan (ASBJ), was established. The number of companies that have applied IFRS in Japan on a voluntary basis rose to 20 as of the end of May 2013, including companies that have publicly announced its future application of IFRS.

With the purpose of helping stakeholders prepare further responses, the Business Accounting Council have decided to summarize its present policy on the application of IFRS by taking into account the previous discussions and recent developments in Japan and overseas.

2. Basic Ideas on the Application of IFRS

Globally achieving an objective recommended in the declaration by leaders at the G20 Washington Summit in 2008, “creating a single high-quality global standard,” is beneficial from the viewpoint of enhancing the efficiency and the vigor of the global economy. Furthermore, the proactive approach by Japan to realize the above objective is considered to be not only useful for Japanese companies to conduct business activities and raise funds, but also important for Japan to ensure the international competitiveness of the Japanese market.

In addition, the efforts of convergence in the past have made the Japanese accounting standards high quality and globally comparable ones and the European Commission evaluates that the generally accepted accounting principles in Japan (Japanese GAAP) are equivalent to IFRS. However, it is necessary to continue making efforts to seek global harmonization of accounting standards. As long as the harmonization will enable Japanese GAAP a set of higher quality accounting standards, it is important to promote the

harmonization proactively and maintain the quality of Japanese GAAP at a high level.

Since IFRS should be continuously improved with the participation of global stakeholders, it becomes more important for Japan to ensure that it has a voice in development process of IFRS. To do so, it is necessary to further clarify Japan's attitude toward IFRS, while continuing the contribution of human resources and funding to the IFRS Foundation and paying due attention to "the use of IFRS (prominent use of IFRS through mandatory or voluntary application)," a membership criterion of the IFRS Foundation Monitoring Board. This is considered to be desirable in helping domestic companies determine whether they should apply IFRS. In doing so, it is necessary to keep in mind that the existing IFRS include items that are hard to be accepted as basic concepts, items that do not fit with the reality of Japanese business management and business activities and cost too much to introduce, and items that are under development by IASB. At the same time, it is necessary to fully pay due attention to the fact that uncertainty exists about the international developments, such as the situation in the U.S.

As mentioned above, while there have been various moves around the world to achieve the global objective of achieving a single set of high quality global accounting standards, the next few years are an important time for Japan from the viewpoint of how Japan should become involved in this formulation.

Based on the above recognition, the plenary and the Business Accounting Council have decided to summarize its opinions on "Relaxation of statutory requirements for eligibility to voluntary application of IFRS," "A Process to incorporate IFRS" and "Simplification of the disclosure of non-consolidated (single-entity) financial statements" as the present policy on the application of IFRS, since building up the examples of voluntary application of IFRS is considered to be important. The details are given below.

The regulatory authority and other relevant stakeholders should appropriately prepare detailed provisions for these issues.

In connection with responses to these issues, financial instruments exchanges are

expected to take the application of IFRS into account when selecting companies that constitute the new index to be developed. In addition, other stakeholders are expected to consider if there are any other measures to be taken for building up the examples of voluntary application of IFRS.

On the other hand, it is believed that the time has not yet arrived to make a decision on mandatory application of IFRS in Japan when taking into account the various situations mentioned above. It is appropriate that stakeholders will deliberate on this point with due attention to international developments, such as the situation in the U.S. and development of IFRS, while verifying the degree of achievement of the measures taken this time including a change in the number of companies that have applied IFRS on a voluntary basis. In case mandatory application of IFRS is decided, it is necessary to set a sufficient period for preparation.

Furthermore, all stakeholders must continue cooperative action to strengthen Japan's capability to have its opinions heard in IFRS and to mitigate uncertainty about the adaptation of practices upon the application of IFRS.

The council's policy on the use of different sets of accounting standards for consolidated- and non-consolidated financial statements and policy that keeps non-listed small and medium-sized entities unaffected by IFRS presented in the Previous Discussion Summary should continue to be maintained.

3. Relaxation of statutory requirements for eligibility to voluntary application of IFRS

Under the current regime for voluntary application of IFRS, Japanese companies those satisfy the following requirements are defined as "Specified Companies" and are given the option to prepare their consolidated financial statements by applying IFRS (Regulations for Terminology, Forms and Preparation of Consolidated Financial Statements Article 1-2).

(1) Being a listed company in Japan,

- (2) Having established an appropriate internal framework for IFRS-based consolidated financial reporting, and
- (3) Conducting financial or business activities internationally (such as having an overseas subsidiary with two billion yen or more of paid-in-capital)

Recently, there has been a growing need for enhancing the international comparability of consolidated financial statements with global competitors within same industries. Considering such significance for increasing comparability, it is considered unnecessary to confine voluntary application of IFRS to companies that meet all the above requirements. It is also necessary to pay due attention to the fact that there are companies that receive extensive investment from overseas and some of them do not meet all of the above requirements. Therefore, the requirements for voluntary application of IFRS should be relaxed to improve the current system so that companies that have the willingness and capability to prepare appropriate IFRS-based consolidated financial statements can apply IFRS on a voluntary basis. This can be considered meaningful to show that Japan is moving progressively toward its objective to achieve a single set of high quality accounting standards.

Relaxing requirements for voluntary application of IFRS is expected to increase the number of Japanese companies that apply IFRS on a voluntary basis, and to ensure that Japan has a voice in development process of IFRS.

In addition, since relaxing requirements for voluntary application of IFRS reduces the burden of IPO companies that hope to apply IFRS from the stage of preparation for the listing, it is also useful from the viewpoint of fostering emerging equity markets.

Even if two requirements for voluntary application of IFRS—being a listed company in Japan and conducting financial or business activities internationally—are eliminated, it is considered that the quality of financial statements will not deteriorate as long as the remaining requirement—having established an appropriate internal framework for IFRS-based consolidated financial reporting—is satisfied. It is also pointed out that it

should be accepted that companies prepare financial statements using different accounting standards temporarily in the convergence process of accounting standards.

In light of the above, among the requirements for voluntary application of IFRS, “Being a listed company in Japan” and “Conducting financial or business activities internationally” should be eliminated, while retaining the requirement “Having established an appropriate internal framework for IFRS-based consolidated financial reporting”. This will lead to a substantial increase in the number of eligible companies for voluntary application of IFRS.

4. A Process to incorporate IFRS

Under the current system, IFRS used by Japanese companies that apply IFRS on a voluntary basis should be confined to “Designated IFRS”, which is specified by the Commissioner of the Financial Services Agency (Regulations and Terminology, Forms and Preparation of Consolidated Financial Statements, Article 93). When specifying “Designated IFRS,” the current framework allows the Commissioner not to designate some particular standards, but it does not provide a framework to modify some particular standards. At the present moment, all IFRS and IFRIC interpretations published by the IASB are specified as “Designated IFRS.”

Although the method of incorporating IFRS differs from country to country, endorsement process (process to incorporate IFRS into the national standards) has been introduced in many countries and regions. The current designated IFRS can be sort of an endorsement, because the current framework allows the Commissioner not to designate some particular standards. However, it has been the application of pure IFRS, because it does not provide a framework to modify some particular standards. In addition, considering that there are companies that apply IFRS on a voluntary basis with the intent to apply pure IFRS, it may be necessary to maintain the system to allow pure IFRS application. In regard to this point, the method to designate pure IFRS in Japan should be

considered again.

Under such a situation, while continuing to allow the use of pure IFRS, creating an endorsement system that examines individual standards from the Japan's viewpoint of "IFRS as they should be" or "IFRS suitable for Japan," and adopts the standards after deleting or revising some standards as necessary, is considered useful for the purpose of ensuring implementation of flexible responses in Japan, including leaving room to seek responses that are suitable for Japan at the time of emergency, such as the latest global financial crisis, while trying to increase the number of companies that apply IFRS on a voluntary basis.

In addition, since accounting standards which reflect Japanese perspectives on IFRS represent suitable IFRS from the Japanese view point, it is useful for Japan to continue presenting its opinions to the IASB. However, it is necessary for Japan to clearly explain the international community that introducing endorsement process in Japan is a proactive step as part of its efforts to seek global harmonization of accounting standards.

It is pointed out that this proposed system is difficult to understand and may cause inconvenience to users, because of the coexistence of four standards: Japanese GAAP, U.S. GAAP, pure IFRS and accounting standards which reflect Japanese perspectives on IFRS. In regard to this point, efforts to the goal of a single set of high quality global accounting standards applied globally, such as presenting opinions to the IASB and making efforts toward a convergence, should be continued, and it is appropriate to regard the coexistence of these four standards as an intermediate step in the dynamism of the convergence of accounting standards.

When specifically examining the endorsed IFRS in Japan, in light of the fact that there are some companies that are willing to apply the accounting standards which reflect Japanese perspectives on IFRS, it is necessary to consider the facts so that the accounting standards which reflect Japanese perspectives on IFRS are useful for these companies while paying due attention to such needs. In addition, the accounting standards which

reflect Japanese perspectives on IFRS should be positioned as a set of accounting standards that are designed for voluntary application, without any prejudgment on mandatory application. Furthermore, it is needless to say that even if endorsement process for IFRS is introduced in Japan, it is important to continue making efforts proactively to improve the current Japanese GAAP.

Regarding specific endorsement process in Japan, it is appropriate that the Accounting Standards Board of Japan (ASBJ), which has the capability of accounting standard development, should first examine the standards; and then the Financial Services Agency should designate individual standards those were examined by the ASBJ, in the same manner used to designate the current Japanese GAAP.

As the criteria for endorsing individual standards of IFRS, due attention should be given to the following points from the viewpoint of public interest and investor protection.

- Fundamental philosophy on accounting standards
- Difficulties in practice (preparation costs exceed benefits etc.)
- Relationship to relevant peripheral regulations (whether various business regulations make it difficult, or cause huge costs to adopt)

On the other hand, the more items those are deleted or revised, the less chance the standards will be internationally regarded as equivalent to IFRS. Consequently, it may cause some difficulties for Japan to ensure that it has a voice in development process of IFRS. Therefore, items that are deleted and revised should be limited to a range that can be reasonably explained to the global community, with the purpose of achieving a single set of high quality accounting standards, while paying due attention to Japan's national interests.

The ASBJ is expected to promptly examine the endorsement based on this policy.

5. Simplification of the disclosure of non-consolidated (single-entity) financial statements

In Japan, listed companies are required to prepare two sets of financial reports:

“financial report prepared in accordance with the Financial Instruments and Exchange Act (FIEA)” and “financial report prepared in accordance with the Companies Act.” These financial reports consist of two different financial statements: non-consolidated financial statements of an individual company, an issuer of the financial reports, and consolidated financial statements of the group consisting of the issuer and its subsidiaries.

Regarding financial statements prepared in accordance with the FIEA, consolidated (group) financial statements are treated as the principal financial statements and non-consolidated (single-entity) financial statements are treated as the secondary financial statements. On the other hand, regarding financial statements prepared in accordance with the Companies Act, non-consolidated financial statements must be prepared by all companies; however, consolidated financial statements must be prepared only by large companies or companies that are subject to the FIEA.

Although the current disclosure system under the FIEA requires companies to disclose both consolidated and non-consolidated financial statements, it should be examined that the simplification of the disclosure of non-consolidated financial statements as consolidated financial statements has been regarded as the principal financial report and non-consolidated financial statements has been regarded as only secondary financial statements.

In addition, companies that are subject to the FIEA are required to prepare consolidated and non-consolidated financial statements in accordance with both the FIEA and the Companies Act. As non-consolidated financial statements under the Companies Act are different from those under the FIEA, preparation of two different sets of non-consolidated financial statements would have been a double burden for issuers.

On the other hand, there are views that non-consolidated financial statements would be as important as consolidated financial statements for companies which financial statements of parent company consists of substantial portion of the consolidated financial statements or for companies which have significant inter-companies transactions between a parent

company and its subsidiaries. Those who expressed the views pointed out that careful examination should be made to determine which disclosure can be eliminated on the non-consolidated financial statements.

Accordingly, the disclosure of non-consolidated financial statements prepared in accordance with the FIEA should be simplified, considering the following aspects.

- Regarding the non-consolidated primary financial statements (balance sheets, statements of income and statements of changes in net assets), both non-consolidated financial statements under the FIEA and the Companies Act should be prepared in accordance with the requirements under the Companies Act, because non-consolidated primary financial statements under the FIEA and the Companies Act are not greatly different from each other, as a majority of the companies prepare non-consolidated financial statements under the Companies Act in accordance with the format provided by the Japan Business Federation.
- Regarding footnote disclosures, the supplementary schedules and descriptions of major assets and liabilities, both sets of disclosures under the FIEA and the Companies Act should be prepared in accordance with the requirement under the Companies Act, as long as current disclosure requirements for these two sets of disclosures do not have major discrepancies. In addition, if sufficient disclosure is made on the certain item on consolidated financial statements prepared in accordance with the FIEA, the disclosure of non-consolidated financial statements would be exempted. Regarding the items related to non-consolidated financial statements, other than those discussed above, an examination should be made whether current disclosure should be kept, taking into consideration on their relevance, the needs of financial statements users, the costs of issuers, the disclosure requirement in other jurisdictions and implications on financial statements audit.
- In order to simplify the disclosure of non-consolidated financial statements prepared in accordance with the FIEA, expansion of segment information on

consolidated financial statements or additional disclosures in annual report outside of financial statements should be examined, in order to address the concerns over reduction of information on a non-consolidated financial information and to achieve convergence of non-consolidated financial statements under the FIEA and the Companies Act.

- There are companies that prepare only financial information on a non-consolidated basis (, for example, the company which does not have any subsidiary). If the simplification of the disclosure of non-consolidated financial statements is applicable to those companies only prepare non-consolidated financial statements, the simplification may widen the disparity in the level of disclosures between the companies that prepare consolidated financial statements and the companies that prepare only non-consolidated financial statements, because the simplification of non-consolidated financial statements of those companies cannot be substituted by information on consolidated financial statements. Therefore, the simplification of the disclosure of non-consolidated financial statements should not be applied to the companies that prepare only non-consolidated financial statements.
- The government authorities in charge of certain regulations require preparation and reporting of financial statements and disclosures in particular formats for the companies in certain regulated industries, in order to achieve the regulatory objectives. Ordinance on Terminology, Forms and Preparation Methods of Financial Statements provides special treatments for the companies in the regulated industry to prepare the financial statements under the particular format, on behalf of the Ordinance, as the disclosure under the format provide relevant information of the companies in regulated industries. In addition, there is a view that the non-consolidated financial statements provide particularly relevant information for the companies in the regulated industries. Accordingly, when considering the simplification, an examination should be carried out for the points discussed above, while hearing from

relevant regulators.