

Chapter 7 Kobe Forum Perspectives on Japanese Accounting and Management Research¹

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Abstract

The seven papers presented at the 2008 Kobe Forum report important and interesting results from Japanese research on accounting and management. In Japan, the focus of accounting on helping management operate the firm efficiently has yielded great economies. In contrast, the single-minded focus of the IFRS, based on investor and security market orientation of U.S.-U.K. accounting, does not serve the Japanese economy well. The dysfunctional consequences of the attempts to force convergence of Japanese financial reporting to IFRS can be seen in the weaknesses of the so-called fair value accounting and in accounting for business combinations. Probabilistic purchase method of accounting for business combinations is a promising alternative. Measurement of performance of corporations can be advantageously expanded beyond the concerns of shareholder to include the interests of other stakeholders in the corporation. The technological success of Japanese manufacturers in the recent decades has been accompanied by strong focus on value creation but inadequate attention to capturing the value for the shareholders. Finally, experimental research on laboratory games with Japanese subjects tends to debunk the theories

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about national traits so popular in comparisons of economic performance and behavior across countries.

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Kobe Forum Perspectives on Japanese Accounting and Management Research

Let me start with the main ideas I learned at this Forum.

Prof. Nakano Tsuneo (2008) addressed a fundamental and important question: what is the purpose of accounting and who does it serve? In Japan, accounting and financial reporting have been focused largely on facilitating efficient manufacturing and other operations of firms. As Japanese firms formed subsidiaries or joint ventures abroad, they were exposed and even pressed to adopt international accounting standards. These standards, based largely on U.S. and British practices, are focused on facilitating efficient investor decisions through security markets. The movement to harmonize the accounting practices of Japanese companies with such international standards does not necessarily help maintain or improve the efficiency of their operations.

Prof. Nakano's perspective on problems associated with international convergence to a single point of view are shared by many accounting thinkers in Europe and U.S. When the IASB issued its conceptual framework proposing that the primary purpose of financial reporting should be to help investors make better decisions, many objections were raised because such a perspective ignores the stewardship and operational roles of accounting emphasized by Prof. Nakano in his address. As I

have written elsewhere (Dye and Sunder 2001, and Sunder 2002 a, 2007, and 2008), the benefits of international harmonization of financial reporting have come to be over-emphasized by those who are in the business of writing international accounting standards, and it is up to accounting academics to analyze the validity of their claims.

I am delighted to learn about Prof. Matsumoto's (2008) research on developing measures of social value of the firm. In an earlier Japanese approach to corporations, insufficient attention was paid to the dividends and other interests of shareholders. In the recent decades, the emphasis has swung to an excessive focus on dividends, residual income and other aspects of the firm which are of interest to the shareholders at the cost of lesser attention to the interests of other stakeholders such as employees. Fact is that the value added by corporations to society includes not only the value to the shareholders but also to other parties. Income to shareholders alone cannot, therefore, be a reasonable basis to assess the value a firm adds to society (Sunder 2001).

For this reason, Prof. Matsumoto's work at Socio-Economic Productivity Headquarters to develop indicators for intellectual social and environmental capacities of firms is insightful and important. His suggestion to use value added per employee is an important measure not only for society as a whole but also of the loyalty of employees towards the firm. He proposes value added per unit of carbon dioxide emission as a measure of environmental capacity. Measures of social capacity present difficult challenges he is now trying to address. I believe that these indicators, individually and combined together in some appropriate fashion, may yield a quite different picture of contributions of firms to society than earnings or rate of return on investment, and will serve as a better basis for many decisions on corporate governance and public policy.

Prof. Yosano's study (Yosano and Shimada 2008) presents excellent insights into Japanese accounting for consolidation, mergers and related activities. Although the FAS and IFRS prohibit its use, Japanese standards permit pooling-of-interest accounting and therefore the European Unions asks for supplementary statements for Japanese firms that use this method of accounting. Under purchase method, Japan permits recording of goodwill which is amortized over no more than a twenty-year period. The mergers and acquisitions markets in Japan have developed rapidly after the commercial code was amended in 1999. He reports that the purchase accounting firms who immediately write down their acquired goodwill do better in the stock market than those who amortize it over time. Within the class of purchase accounting firms who amortize goodwill over time, firms which have had another business combination in the past do not do as well as first-time purchasers. On the whole, pooling firms' stock market performance subsequent to the transaction is better:

Prof. Yosano's findings highlight two issues. First is the reflexivity of accounting—accounting not only captures the way things are, it also helps determine what they are. Thus, accounting is not a mere eye-in-the-sky that observes and records the prevailing state of affairs unobtrusively. Instead, managers of business can be thought of as a model before the camera (of accounting); when the camera points to the model, the model poses and smiles. Consequences of ignoring this reflexivity of accounting, and making accounting rules as if they have no impact on the substance of the business transactions they capture, is inappropriate. Interaction between accounting and business decisions is an essential aspect of the game financial engineers and investment bankers play. The second issue is the difficulty of drawing causal inference from observed statistical correlations in data. The finding that the stock performance of firms that amortize goodwill gradually is not as good as the

performance of firms that write it off immediately cannot be used to infer that immediate write off is a better method of accounting, even from the shareholders' point of view. It could simply be the case that firms in stronger financial position tend to write off goodwill and this preference shows up in the better performance of stock returns for such firms.

Prof. Nobeoka's (2008) presentation about organizational strategy, the only non-accounting paper in the Forum, is fascinating. He points out that all sectors of Japanese industry have seen a secular decline in profitability (operating income/sales ratio) over the past forty years, with the possible recovery of the steel industry being the sole exception. While Japanese firms continue to innovate, design, and produce new products, they do not necessarily make profits. Chinese firms, in contrast, are able to make profit by cutting costs through modularization made possible by availability of components in open market.

Prof. Nobeoka suggests that Japanese firms excel in creating value through quality, cost and speed, but not in capturing the value for their shareholders. They are not able to include capture of value in their mind set which is still fixed on value creation. The result is that they design and produce hundreds or thousands of variations of their products, mostly without patent protection, and achieve lower profitability. In contrast, U.S. firms begin their planning process with a strategy to capture value. Japanese firms could benefit by shifting their focus from producing perfect products to merely superb products and be more profitable if they focus their attention on product features that their customers are willing to pay for. When technology exceeds the customer needs, products become commodities. Digital cameras beyond 10 mega pixels, for example, exceed what customers want and are willing to pay for; Japanese manufacturers' focus on additional features in such products slow them down as leaders, allowing followers to catch up with them.

Prof. Nobeoka argues that successful firms attract emulators and they remain successful by pursuing both functional as well as non-functional values of their products. Functional features determine the price of the product but firms survive by creating non-functional values such as status symbol which appeal to individuals. He used the example of Henry Ford who started mass production of cars and brought the costs of production down. Alfred Sloan of General Motors, on the other hand, overtook Ford by his approach of segmenting the car market by aspired level of status among Chevrolet, Buick and Cadillac divisions. He concluded by emphasizing the importance of both functional and non-functional domains, and accumulation of organizational capabilities of both kinds, for success of a corporation. He thinks the Japanese industry suffers from ignoring the non-functional values.

I took away three thoughts from Prof. Nobeoka's presentation. First, excessive dependence on a single criterion of performance often leads to poor performance. I am reminded of the TOM movement popularized in the U.S. during the 1980s. Its advocates insisted that quality is the only thing that matters for success of a corporation. It took them a few years to discover that pursuit of quality without consideration of costs and values, and their trade-offs, is a ticket to poor performance, if not bankruptcy of the firm. If we were to consider the multiple dimensions of performance discussed earlier by Prof. Matsumoto, it may well be that the performance of Japanese corporations may be better in spite of the share of the shareholders being smaller. Validity of this proposition would be worth examining with data. Third, I cannot help but think that the reputation SONY Corporation enjoyed in the 1970s and 1980s seems to be associated with Apple today, the manufacturer of Mac computers, iPods, and iPhones, in 2000s. Why and how did this transformation come about? What, if any, is the importance of nationalities traditionally associated with these corporations?

This brings me to Prof. Yamaji's (2008) interesting and energetic presentation. He used results from experimental laboratory games with Japanese subjects to raise provocative questions about the validity of some prevalent theories about Japanese accounting and management. He suggests that until the 1960s, success of the Japanese economy led to appreciation of its dual structure consisting of Marxian monopolies and smaller competing firms. In the 1970's came the turning point when the success of Japanese management was attributed to the psychology of reciprocity, altruism, and harmony. A quarter century later, after two decades of stagnation, today Japanese management is no longer held in such high regard.

Three aspects of Japanese accounting—accrual cost basis, realization principle, and historical cost basis—supported Japanese style of management. For example, reserve for retirement costs enforced by accrual cost basis and ban on upward revaluation of land and other assets enforced by historical cost basis and realization principle prevented exodus of funds from firm to the market. Since Japanese corporations tended to retain their employees for their lifetime, reserves for retirement costs accumulated funds within corporations over long periods of time. Ban on upward revaluation of land prohibited excessive dividend based on unrealized revenue, and thus helped accumulate funds within the corporations to support the values of their securities. The ban on upward valuation also forced firms who felt pressed to report higher income to sell their appreciated assets to realize the profits. Thus accrual, realization and historical cost principles served the needs of management well. In practice, they also allowed the parent companies to distribute their profits to subsidiaries through recognition of intra-group sales. Banks were the mainstay of corporations with land as the primary collateral. Historical costing prevented revaluation of land, and its outflow from corporation to the market place, as we have already discussed. Thus the accounting system supported the Japanese style of corporate

management.

In management literature, Japanese psychology is said to be conciliatory, altruistic, and reciprocal and provides fertile environment for quality circles and other joint product endeavors. Experimental studies, on the contrary, suggest that Japanese psychology is spiteful, instead. In a public good game among Japanese players, if a player does not contribute to public good, others tend to retaliate. Japanese are keener on being relatively better off than being better off in absolute terms. Thus, they tend to choose a reward of 80 for self and 70 for others, instead of a reward of 100 for each. Japanese contribute to public goods not because they prefer production of public goods per se, but for the fear of being sniped at by others if they do not contribute.

In Japanese manufacturing, simultaneous engineering by suppliers produces components even before an order to produce them is received, and it is admitted for saving time. But in fact, it is simply a survival method for the smaller component suppliers who struggle under the thumb of the exploitative powerful assemblers. Such small manufacturers have no alternative but to produce in advance of the orders so they can be filled immediately.

In experiments on collusive bidding, introduction of non-Japanese bidders tends to preclude bid-rigging early on. However, over time, bid prices rise for all, including the bids of non-Japanese bidders even if they are kept outside the room beyond visual contact with the rest of the group. These results suggest that the behavior is driven by the profit motive and not by any cultural or national traits. Japanese government itself acquiesces to some collusion in bidding believing that it may help assure higher quality of the public goods it purchases.

As Prof. Matsumoto suggested, Japanese are highly concerned with the distribution of value and therefore they prefer an accounting system in which every one

is informed about what everyone else gets. This is reflected in the work of Prof. Nozbecka. In discussions of international accounting, national and regional characterizations are often used. Whether there are such differences across national characters remains to be established.

Prof. Yamaji suggests that research findings from laboratory experiments raise questions about the validity of attributing either the successes or the failures of Japanese business to the personality attributes of the Japanese people.

This Japanese conference is, understandably, conducted in a self-critical mood. I seem to be the only non-Japanese in this big room. I cannot help but ask: Does nationality really matter? Or are the so-called nationality traits merely a matter of variations in expectations shared within a society but not across societies. Our expectations are built from our past experiences. What would happen if we conducted an experiment with people drawn from various societies, with the condition that all of them have had similar relevant experiences in their past? Such an experiment is virtually impossible to conduct because it would be difficult for people drawn from different societies to have had the same experiences. Still, I am inclined to believe that the results of such an experiment will depend on past experiences, not on nationalities. After all, culture is the common knowledge expectations of what the members of a group expect others to do in various circumstances (Sunder 2002 b). These expectations derive from experience, and variations in these experiences, not some inherent traits, differentiate the behavior of the members across societies.

In his presentation, Prof. Nakano Isao (2008) presents an innovative alternative called "probabilistic purchase method" of accounting for mergers and acquisitions when both firms are of the same size and it is not possible to determine with certainty which firm is the acquiring firm. Under this method, the financial statements of the merged firm would be the average of the financial statements that re-

sults when A acquires B and the financial statements that result when B acquires A. On the other hand, when the acquiring firm can be identified, the standard purchase method can be used.

Prof. Nakano presents an extensive argument in favor of probabilistic purchase method of accounting. Recall, that while Japanese accounting standards permit pooling-of-interest accounting for M&A, International Financial Reporting Standards (IFRS) do not. In the purchase method of accounting, financial statements of the acquiring firm retain their book values while the acquired firm is revalued. This allows the success of the merger transaction to be assessed by comparing the pre- and post-merger rates of return. Thus this accounting method can be said to provide information which is more useful for making better decisions. Of course, the problem with this method is that in case of merger of the equals, it is not clear which firm should retain its book values and which firm should be revalued.

Pooling of interest method of accounting assumes the continuity of business of both firms before and after the merger. The owners' equity remains unchanged due to merger and a merger of equals does not present a problem in this case. However, the financial reports prepared under this method are not representationally faithful because it does not reflect the changed nature, control and use of the resources. It tends to inflate the rate of return of the merged firm because it retains the pre-merger, usually lower, book values of net assets, and not the values that have been verified through an arms-length transaction. Since the financial statements do not incorporate the current values, their power to predict the future cash flows is attenuated.

In case of merger of the equals, Tweedie and Whittington (2000) suggest "fresh start" accounting which requires restatement of net assets of both firms to their current values. This method has the advantage of raising the predictive and

feedback values, and is representationally faithful. It also requires more work and greater cost of revaluation, diminishes comparability with the past data, and makes it difficult to judge the effectiveness of the merger decision (because the pre-merger financial statements are based on historical cost while the post-merger statements are based on current values). The danger of arbitrary use of purchase and fresh start method leads to the suggestion that the latter be reserved only for the mergers of equals, which is a rare event.

Prof. Nakano provides an extensive and insightful history of the development of the current merger accounting standard in the U.S. (SFAS 141). He points out how it ended up being a political compromise between the FASB, accounting theoretical arguments and business interests. While the standard prohibits pooling of interest accounting, it does not require either immediate or periodic amortization of acquisition goodwill. Instead, it recommends an impairment test and calls for goodwill to be written down only when it is impaired—a matter of subjective judgment.

Prof. Nakano proposes that when neither firm can be identified as the acquiring firm, accounts could be prepared as if there is 50-50 chance of each firm being the acquiring firm and each management has the chance of being the dominant group. This will yield financial statements showing an average of assets, liabilities and net assets from the two sets of statements assuming that one or the other is the acquiring firm.

One might extend Prof. Nakano's proposal to all mergers by using probabilities of being the acquirer which are proportional to the size of the respective firms. Properties of such generalization of his proposal remain to be explored.

Prof. Tokuga (2008) gave an excellent background, exposition, and analysis of the consequences of the so-called "fair value" (FV) accounting recently adopted for across the board application by as a part of IFRS. It consists of a mix of three

different principles: mark-to-market as defined by current exit value, mark-to-model and value-in-use.

In the traditional model of accounting, historical cost, matching, income smoothing have been important elements, with net income as the key measure of corporate performance. Allocation of the cost of a plant asset across accounting periods in its life time can be done in an infinite number of ways. Of all possible allocation schemes, a smooth depreciation functions is usually chosen. Income smoothing is useful to balance the interests of various stakeholders and to capture the long-term profitability of the firm in measured income. The ability of the managers to anticipate the future determines their ability to smooth income in interest of the stakeholders. Given the discretion to smooth, there exists the possibility that managers will use such discretion opportunistically to serve their own interests instead of the interests of other stakeholders. This raises the question of whether reported accounting income reflects managers' best estimate or includes distortions driven by their own incentives. Investors can only make decisions on individual firms, and one should not expect that they can arrange managerial incentives to completely eliminate manipulation of accounting.

The IASB appears to have made a broad shift from this flow-based approach to financial reporting and income measurement toward a stock-based approach, and combined it with a shift to the hybrid method labeled FV. This method is no better for eliminating managerial discretion because the responsibility for assessing the valuation of assets and liabilities still lies with them. When sufficiently liquid markets are not available, managers exercise a great deal of discretion in choosing such values, especially when value-in-use method is applied.

One of the consequences of FV adoption is a general decline in the hardness of accounting data. Perhaps the sole exception is when a unique price from a

relatively liquid asset market is available. Hardness declines in application of mark-to-model because the discretion exercised by managers in the choice of assumptions of the model. This decline is even sharper when value-in-use is employed because then the manager must evaluate the firm as a whole. Major accounting firms have already appeared on opposite sides of legal disputes on this matter.

Financial reporting as well as investor behavior were said to suffer from "short-termism" even before the introduction of FV accounting. This accounting method is only likely to aggravate this affliction, especially in Japan where research studies show the institutional investors to be even more short-term oriented than in the U.S.

In shifting the responsibility for assessment of future from investors to managers, FV changes the balance between them in a fundamental way. Consequences of this shift, especially at macroeconomic level remain to be analyzed. Inclusion of FV in corporate accounting will change the facts, issuance of debt and equity securities, listing/delisting decisions, contracts and utility rates. Will the short-term decision horizon of managers create an unstable feedback loop between their expectations (optimism or pessimism), valuations, and lead to market instability?

FV may also cause changes in business cycles although little research has been done on this topic so far. By reporting and emphasizing unrealized gains, will FV accelerate business fluctuations? FV does not permit off-balance sheet buffers in the form of unrecorded self-created goodwill etc. as historical accounting does.

Prof. Tokuga concludes that the choice of FV over HC may lead to higher volatility, greater short-termism, and increased magnitude of business cycle fluctuations. As Professors Nobeoka and Yamaji suggested earlier in the Forum, investment in manufacturing has a longer gestation period and to facilitate efficient decisions in that domain, corporations need smoother measures of performance over longer inter-

vals of time. FV will have the opposite effect of shortening the interval over which performance is measured, and therefore shorten the decision horizons, with detrimental impact on business and macro-economy. We can already see this effect in the form of shortening of gestations periods of research and development projects.

In my assessment, Prof. Tokuga's analysis is both important as well as accurate. I do not believe that the economic consequences of adopting FV have been adequately analyzed and thought through before it was adopted (Sunder 2008). Tendency towards shorter term decision making in investment, financial reporting and executive compensation is understandable, mutually reinforcing, and ultimately harmful. The effect of mark-to-market accounting for liabilities is that firms about to default on their debt will be able to lower their liability, and thus improve their apparent financial performance as reported under FV. Writers of FV standards ignore the information value of accounting choice. When corporations are allowed to choose from a menu of alternative accounting methods (subject to disclosure of the method itself) they reveal additional information about themselves. The subprime financial crisis of 2007-8 reveals that some of the worst fears of the critics of FV may come true. Prof. Tokuga's analysis could not be more timely.

In summary, the seven papers presented at Kobe Forum are enlightening and interesting not only for accounting but also for the broader disciplines of management and economics. They seek to put Japanese accounting in the broader context of the attempts to pursue convergence of financial reporting at a global scale, and its consequences. The real differences of various economies of the world tend to be downplayed in the rush to convergence and harmonization, disregarding their potential for dysfunctional consequences. Among other things, the damage that could be inflicted by a world-wide monopoly of accounting standards on the role of innovation in financial reporting is ignored (Sunder 2009). On the other hand, the differ-

ences among the behavioral traits of individuals across countries tend to be highlighted although there is little evidence that, once stripped of the variations in past experiences that form their expectations, human beings around the world are different in any essential respect. Kobe Forum has brought together an exciting set of ideas on these themes.

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