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Comments on IASB standards intended for SMEs (draft)

The Small and Medium Enterprise Agency of the Ministry of Economy, Trade and Industry of Japan expresses its respect for the IASB's untiring efforts aimed at developing globally applicable accounting standards. The SME Agency wishes to briefly explain how it is addressing this issue as one of Japan's SME-related policies, on this occasion where comments are invited on the discussion papers presented by the IASB relating to its standards applicable to SMEs. The agency would be glad to offer its maximum cooperation if the IASB needs to investigate the situation in Japan for future studies. It is the agency's sincere wish that the IASB will deepen its understanding of Japan's situation, as described below, and draw on it for further study.

1. Background governing our formulation of the "SME Accounting"

Over 5 million SMEs exist in Japan, accounting for more than two-thirds of overall employment and 60 percent of added value. Thus, SMEs can be considered the source of Japan's economic power and, therefore, their healthy development is a key issue in our economic and industrial policies.

At a time when the financial environment and the trading structure that surround SMEs are undergoing drastic changes, it has become necessary for SMEs to win confidence through disclosure based on proper accounting, and developing an environment that responds to such needs is now perceived as an important aspect of SME policies. It is said, however, that in actual business practice SMEs have so far focused their accounting on tax matters, and not disclosed their financial position to parties other than their main banks and business partners. It has also been pointed out that sophisticated new accounting standards, which have been put into effect one after another, are likely be felt by SMEs as a burden too heavy to shoulder, since they are designed for publicly traded, large-scale businesses. Moreover, it was suggested that there should be simplified accounting standards for SMEs. Such a background has increased awareness of the necessity to clarify the kind of accounting that best suits SMEs. Thus, with the participation of a wide range of interested parties, the SME Policy-Making Council's Business System Committee discussed "Accounting for SMEs" and arrived at a conclusion in June 2002. (See the annex for the full text.)

2. Who SME Accounting is targeted at

The SME Accounting is targeted at businesses that are not publicly traded, and that are defined as "small businesses" under the Commercial Code (those capitalized at less than ¥100 million, not being required to be audited by external certified public accountants). The SME Accounting, however, is not meant for venture businesses that are small but aim to go public. Rather, it was compiled from the viewpoint that it is appropriate for such companies to be based on the same accounting standards that apply to publicly traded companies, so as to give continuity to their financial statements. This exception conforms to preliminary view 3.5 in the discussion paper and indicates that the ``SME Accounting`` does not adopt a simple quantitative standard.

3. Developments since June 2002

Even after the formulation, the content of the SME Accounting has been revised as needed in line with the changes made to our corporate accounting standards for entities whose securities have been listed for trading in a public securities market. A specific case is a revision made last year to the SME Accounting to allow for the introduction of Asset Impairment Accounting Standards. As "SME accounting'' themselves are not legally binding, the SME Agency and related organizations are engaged in ongoing activities to diffuse, and educate people on, the standards, in an effort to establish them as new rules with the cooperation of private financial institutions.

4. Future moves

The SME Agency is set to revise whenever necessary the SME Accounting. In fact, the SME Policy-Making

Council's Business System Committee is due to hold a meeting on the 1st of this coming November to discuss reviewing the introduction of accounting standards for business combinations as well as implementing adequate measures for further diffusion of the SME Accounting. In addition, the agency plans to make use of the meeting, at which all the parties deeply involved in the formulation of the SME Accounting will get together, for the exchange of views and ideas on how to address the IASB standards. The agency would be only too pleased to inform the IASB of the outcome of the discussions if so requested.

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Yours sincerely,

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Accounting for Small and Medium Businesses

Introduction

This report presents desirable accounting procedures for small and medium businesses that wish to diversify sources of funding and expand business connections. This is the result of intensive discussion from March to June 2002 by the Conference on Accounting for Small and Medium Enterprises, sponsored by the Small and Medium Enterprise Agency.

Concerning the preparation of financial statements, Japan's Commercial Code states that "fair accounting practices shall be taken into account" when there are no specific provisions in the Commercial Code itself (Commercial Code, Article 32.2). The Commercial Code contains few provisions with regard to accounting, and a reading of these provisions leaves room for a wide range of options. This has not necessarily been clear for small and medium businesses. As a result, many small and medium businesses have based their accounting on the tax laws. (However, Japan's tax laws do include a significant amount of consideration for business accounting.)

The background leading up to this discussion of accounting for small and medium businesses included changes in the business environment affecting small and medium businesses, such as changes in transaction structures and the fact that land-secured financing has reached its limits. There is a growing awareness that to deal with these changes, active disclosure of reliable financial statements is an important step for small and medium businesses which are engaged in management innovations and wish to expand their business connections and obtain additional sources of funding. Also, the question of how to respond to small and medium businesses which have trouble dealing with the increasing complexity of international accounting standards is a major issue not only for Japan but in every country.

Based on the above concerns, the Small and Medium Enterprise Agency decided to conduct a study to identify "fair accounting practices" for small and medium businesses under the Commercial Code, taking into consideration the different attributes which are dependent on business size, the costs which small and medium businesses can afford, and the purposes of financial statements.

The nature of this report is not to place requirements on small and medium businesses, but to indicate desirable accounting practices. It is hoped that this report will serve as an impetus to further debate on the improvement of accounting practices at small and medium businesses.

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I. Accounting for Small and Medium Businesses (General Themes)

Purpose:

The purpose of this discussion is to clarify the desirable accounting methods to be followed in the preparation of financial statements under the Commercial Code by small and medium businesses that wish to diversify sources of funding and expand business connections.

Commercial Code, Article 32

[1] A merchant must prepare accounting ledgers and balance sheets to indicate the situation of business assets, profits and losses.

[2] Fair accounting practices shall be taken into account in the interpretation of rules concerning the preparation of commercial ledgers.

Commercial Code, Article 281

[1] The directors shall prepare the documents listed below, along with the respective supporting schedules, for every accounting period; and shall obtain the approval of the Board of Directors.

i. Balance sheet
ii. Profit and loss statement
iii. Business report
iv. Profit appropriation and loss disposition proposal

Approach

All companies are required to prepare financial statements under the Commercial Code. Other than the rules on accounting for joint-stock companies and rules for commercial ledgers which are given in the general provisions of the Commercial Code, this law states that "fair accounting practices shall be taken into account" with regard to the preparation of these financial statements. There is considered to be a range of options for accounting rules under the Commercial Code.

In Japan, the Business Accounting Standards issued by the Business Accounting Council on the basis of the Securities and Exchange Law are applied to publicly held companies, as a general rule.

Privately held companies that are defined as large companies under the Commercial Code are required to prepare financial statements under the same kinds of standards as publicly held companies, based on inspection by a certified public accountant under the Law for Special Exceptions to the Commercial Code.

Meanwhile, for privately held companies that are defined as small and medium companies under the Commercial Code, the question of what is meant by "fair accounting practices" has not necessarily been clear to the small and medium businesses themselves. The Business Accounting Standards which publicly held companies are required to follow, including the so-called new accounting standards, are not clearly required of privately held small and medium businesses under the Commercial Code; so individual interpretation is needed from the standpoint of the Commercial Code based on the provision on taking "fair accounting practices" into account under Article 32.2 of this law.

Companies which are classed as small and medium businesses are actually very diverse in size, type of industry, and other characteristics. At present, the accounting procedures of small and medium businesses are handled according to a wide range of methods, depending on the situation of the company.

For small and medium businesses to develop new business connections and obtain additional sources of funding that do not depend on physical collateral or personal guarantees, it will be important for them to prepare and disclose reliable financial statements to improve their creditworthiness in the future. With the April 2002 revision of the Commercial Code, businesses may use low-cost Internet publication for disclosure under this law. Now that the disclosure of financial statements is practicable, there is a significantly higher need for small and medium businesses to understand what constitutes reliable financial statements.

This report indicates the desirable accounting methods to be followed in the preparation of financial statements under the Commercial Code by forward-looking small and medium businesses that wish to diversify sources of funding and expand business connections. These are not requirements for all small and medium businesses. Rather, these are useful guidelines for small and medium businesses that are oriented to new business development.

Also, guidelines with desirable accounting methods that are identical or basically equivalent to the requirements for publicly held companies would not be practical for small and medium businesses. Therefore, the guidelines in this report are desirable methods which are fully adequate to obtain the trust of creditors and business connections of small and medium businesses.

A variety of different perspectives apply to the accounting of small and medium businesses in a complex manner. These include the perspectives of the Commercial Code, tax laws, business accounting principles, and clerical processing based on the type of business operation. However, the objectives and rules of the Commercial Code are the basic framework for considering the accounting of small and medium businesses. For joint-stock companies, it is important to maintain company assets from the standpoint of protecting creditors in order to uphold the principle of limited liability for shareholders. Therefore, it is necessary to properly calculate the amounts available for dividends. Also, for decision-making by creditors, shareholders, and other stakeholders, it is essential to be able to grasp the situation of company assets, profits and losses. For these reasons, the Commercial Code provides rules on financial calculations by companies and regulates company accounting.

Based on the purpose and framework of the Commercial Code as discussed above, it is necessary to identify the accounting methods which are desirable for forward-looking small and medium businesses from the treatment of tax laws and business accounting principles, with thorough consideration for current practices and practicability for small and medium businesses.

Considering the different purposes of each of the relevant systems, it is extremely difficult to formulate consistent guidelines that fully reflect these different systems and their standpoints. However, small and medium businesses are, in fact, conducting their daily business activities under a variety of different systems. The purpose of this report is to provide guidelines for dynamic small and medium businesses with the rules of the Commercial Code as the basic framework, respecting each of these systems and indicating desirable accounting methods that are practicable for small and medium businesses.

Applicable companies:

These guidelines apply to companies which are defined as small companies under the Law for Special Exceptions to the Commercial Code (joint-stock companies with capital of 100 million yen or less) and which do not intend to publicly offer stock for the time being. These guidelines do not apply to publicly held companies or the subsidiaries of companies which are defined as large companies under the Law for Special Exceptions to the Commercial Code.

Approach

Before addressing the accounting of small and medium businesses, it is necessary to consider the scope of applicable companies. Since the purpose is to indicate desirable accounting methods for small and medium businesses, which are regulated under the Commercial Code, it seems appropriate to follow the approach used by the Commercial Code (classification based on capital) to define the applicable companies.

It is proper to assume that this report will apply to companies which are defined as small companies under the Law for Special Exceptions to the Commercial Code (joint-stock companies with capital of 100 million yen or less). The reason is that disclosure of financial statements will become an important issue for small companies, of which there are currently 1.05 million; and therefore a clear indication of the desirable accounting methods is of great importance. Also, the sound development of small companies is considered to be an important issue for the national economy.

The great majority of small companies do not intend to publicly offer stock, and they are closed companies with share transfer restrictions. Companies that do intend to publicly offer stock, even if they are currently small in scale, should handle their accounting in the same way as publicly held companies from the standpoint of continuing usability of their financial statements, persuasion of future external investors, and so on. Therefore, they can be excluded from the scope of discussion.

Meanwhile, there are about 25,000 companies which are defined as medium companies under the Law for Special Exceptions to the Commercial Code (companies with capital of more than 100 million yen but less than 500 million yen, and total liabilities of less than 20 billion yen), fewer than the number of small companies. However, they are larger in scale and are more likely to become listed in the future. Also, under the revision of the Commercial Code which was passed and adopted in the 2002 regular session of Parliament, medium companies which are audited by a certified public accountant can enjoy the same benefits as large companies under the Law for Special Exceptions to the Commercial Code. Therefore, medium companies have a high degree of similarity to large companies, while they show qualitative differences from small companies, including the aspect of expanding economic connections. It is considered inappropriate to include such companies uniformly in the current discussion. However, this discussion of desirable accounting methods for small companies may also serve as a useful guide to privately held medium companies.

Limited companies prepare their financial statements in accordance with the rules for financial statements of joint-stock companies, and their treatment under the Corporation Tax Law is the same as for joint-stock companies. Therefore, when desirable accounting methods are presented for small companies under the Commercial Code, limited companies may use this as a guide in preparing their financial statements.

Based on the above, it is considered that this report will provide guidelines on desirable accounting methods primarily for small companies under the Commercial Code which do not intend to publicly offer stock; but that these guidelines may also be useful for limited companies and for some medium companies which do not intend to publicly offer stock.

As a general rule, this report does not apply to consolidated groups. The Commercial Code does not require the preparation of consolidated financial statements by consolidated groups of privately held small and medium companies under the Commercial Code. (A revision to this law requiring large companies to prepare consolidated financial statements has now been passed and adopted in a regular session of Parliament.) Clearly, the approach of a small or medium company to business organization is an important issue in terms of its management strategy, and questions related to accounting for the consolidation of small and medium companies will be an important topic for future discussion.

Decision framework:

The following is the basic decision framework for the discussion of accounting for small and medium businesses, based on the objectives and purpose of the Commercial Code.

(1) To provide information that is useful for the users of financial statements, particularly creditors and business connections.

(2) To be understandable to business administrators, and for the financial statements prepared on this basis to contribute to a grasp of the company's own financial condition.

(3) To avoid placing an excessive burden on the applicable companies (to be practical and feasible).

(4) To take existing practices into consideration.

(5) To provide a range of options for accounting methods, based on the company's environment and industry type. To recognize the option of simpler methods that may be used instead, where such methods exist.

Approach

The purpose of this report is to propose desirable accounting methods from the standpoint of small and medium businesses as the "fair accounting practices" to be taken into account by forward-looking small and medium businesses (small companies under the Commercial Code) that wish to diversify sources of funding and expand business connections. Therefore, viewpoints that are characteristic of small companies will come into play under the rules, purpose, and objectives of the Commercial Code. The fundamental basis of this discussion will be the standpoint of true usefulness and practicality, since the subject is a real economic system.

Here, we have listed five basic approaches to the discussion of accounting for small companies.

(1) This reflects the perspective of the users of the financial statements of small and medium businesses. Even if a certain set of accounting procedures is followed, it is meaningless unless the resulting financial statements provide information that is useful for the main users of these documents. Creditors and business connections are the main users of the financial statements of small companies under the Commercial Code, which are the subjects of the current discussion; so

the primary emphasis must be on usefulness to both these parties.

However, as stated in (3) below, it is possible that these guidelines may not be implemented if they place an excessive burden on the side of the small and medium businesses. Therefore, the proper approach is to require only the matters that are necessary for users of financial statements, with the inclusion of additional desirable information as a voluntary matter.

Also, ownership and administration are unified in the vast majority of the applicable small companies. Therefore, the standpoint of providing information to investors is of a lower priority for these businesses than for publicly held businesses.

(2) This reflects the perspective of business administrators as accounting users. In the past, some business administrators wholly outsourced the preparation of financial statements to external specialists; but recently, as the financial environment and business environment have become more challenging, it has become increasingly important to grasp the financial condition of one's own company by analyzing the figures and to prepare a business plan that is backed up by financial statements.

Therefore, it is necessary for these guidelines to be understandable for most business administrators, and for the financial statements prepared under these guidelines to help business administrators understand their own companies' financial condition.

(3) This approach takes the standpoint of ensuring that the burden on small and medium businesses is appropriate. Small companies under the Law for Special Exceptions to the Commercial Code have an average of about 18 employees, for example. Since they are generally much smaller in scale than publicly held companies, they naturally limit their own personnel burdens and financial costs with regard to accounting. Therefore, a system that necessitates an excessive burden or large external costs will not tend to be feasible. Our attitude must be to focus on accounting methods that will provide the necessary minimum of information which is meaningful for creditors and business connections, under the rules prescribed by the Commercial Code.

(4) This focuses on the approach taken in preparing financial statements. Instead of completely ignoring current accounting practices and the handling of tax laws in the accounting of small and medium businesses, the basic approach will be to respect current practices and draw on existing standards.

In particular, it is important to note that tax filing is one of the major purposes for the preparation of financial statements by small and medium businesses. Japan's Corporation Tax Law focuses on the final settlement of accounts used to calculate taxable income, based on financial statements under the Commercial Code; and there are detailed rules concerning the calculation of profits and losses. In actual practice at small and medium businesses, there has not necessarily been a clear recognition of "fair accounting practices;" and there is a desire to reduce the number of items to be adjusted in tax declarations. Therefore, small and medium businesses have based their accounting on the rules of tax laws alone. Considering the size and business conditions of small and medium businesses, tax declarations have a great deal of significance, and this level of importance will remain constant. The current tax laws include rules on the methods used for calculations, and from the standpoint of accounting practices at small and medium businesses, it is desirable to actively incorporate these rules in the preparation of financial statements under the Commercial Code as long as they are recognized to be "fair accounting practices."

(5) This concerns the methods of accounting. Small companies under the Commercial Code actually vary widely in their situations. There are over two million small and medium corporations including limited companies, and they conduct a variety of business activities, with accounting practices that are suited to each type of industry. Therefore, it is desirable to provide as wide a range of options as possible for accounting at small and medium businesses.

As stated in (3) above, very complex accounting methods would place a burden on small and medium businesses; and moreover, depending on the scale of a company's operations, it might not be able to accept the costs involved in hiring a specialist to handle the accounting. It is desirable to recognize simple methods when these can be used, according to the accounting needs.

Accounting for small and medium businesses must be considered in terms of the five points of the decision framework given above. It is important to apply this decision framework to the greatest extent possible in accounting that is fully reliable and useful for small and medium businesses and the stakeholders of small and medium businesses.

In the specific themes below, the approach to accounting for small and medium businesses will be discussed by individual subject.

II. Accounting for Small and Medium Businesses (Specific Themes)

Basic approach to the preparation of financial statements for small and medium businesses:

The financial statements of small and medium businesses must present a general view of the facts of a company's financial situation and business performance, to the full extent required by the company's creditors, business connections, and other users of its financial statements.

Commercial Code, Article 32

[1] A merchant must prepare accounting ledgers and balance sheets to indicate the situation of business assets, profits and losses.

[2] Fair accounting practices shall be taken into account in the interpretation of rules concerning the preparation of commercial ledgers.

Commercial Code, Article 33

[1] Accounting ledgers must express the following matters in a clear and orderly fashion.

i. At the time of business commencement and once every year at a certain time, the business assets and their value; or in the case of a company, its business assets and their value at the time of establishment and at the time of each closing of accounts.
ii. Trading and all other matters which affect the business assets.

Approach

This is a statement of the basic approach to the preparation of financial statements by small and medium businesses.

Article 32.2 of the Commercial Code states that "fair accounting practices shall be taken into account." The general interpretation of "fair" is that the practices should be suitable for indicating the situation of a merchant's assets, profits and losses.

This is made clear by the phrase "a general view of the facts of a company's financial situation and business performance" in the body text.

The phrase "a general view of the facts" indicates relative factuality. The content constituting the facts will change according to the goals of business accounting at any point in time. For the accounting of small and medium businesses, the judgment of factuality is based on the objectives of financial statement preparation and social demands on accounting at small and medium businesses. The body text stipulates that the specific content must be factual for the users of financial statements of small and medium businesses. Since this study is aimed at accounting that is desirable for small and medium businesses that wish to diversify sources of funding and expand business connections, full consideration must be given to the objectives of accounting and social demands with regard to these kinds of businesses.

The main external users of the financial statements prepared by privately held small companies under the Commercial Code are creditors, including financial institutions, and business connections of small and medium businesses. In most cases, the business administrator himself is the largest shareholder, so the perspective of protecting creditors and business connections is important. Also, since it is assumed that these are privately held companies, less importance is attached to the function of providing information for investors, although this is a major objective of accounting at publicly held companies.

Based on the above considerations, in a study of desirable accounting methods for small and medium businesses, it is necessary to consider the needs of the business administrator and others with regard to the financial statements of small and medium businesses.

In the Business Accounting Standards, the "general principles" under the Business Accounting Principles are taken as the basic approach in preparing financial statements. It is necessary to consider the possibility and extent of their applicability from the standpoint of the Commercial Code (interpretation of "fair accounting practices" for small and medium businesses).

The rules on "general principles" in the Business Accounting Principles agree in large part with the rules and attitudes of the Commercial Code, so these principles will not be redefined here. Specifically, in the interpretation of the Commercial Code, the phrases "the principle of proper bookkeeping" and "the principle of clarity" in Articles 32.1 and 33.1 are considered to have the same significance. The "principle of conservatism" is also appropriate under the Commercial Code from the standpoint of protecting creditors, and the rules include some aspects which seem to be reflections of conservatism, such as compulsory devaluation. Therefore, our interpretation is that this principle is also required under the Commercial Code. Naturally, no problem is presented by the "principle of distinguishing between capital and profit" or the "principle of singularity," so long as the rules of the Commercial Code are upheld.

The "principle of continuity" will be discussed under the following section, "Changes in accounting policy." The "principle of importance" is naturally applicable to all companies, but since the scope of importance varies according to the company, this cannot be uniformly regulated. Judgments in this area should be based on the goal of application within a range that does not affect decision-making by creditors, business connections, or other users of the financial statements of small and medium businesses.

Changes in accounting policy:

Changes in accounting policy must be made for the purpose of producing a more accurate indication of the company's assets, profits, and losses.

Commercial Code, Article 281.3

[1] The auditor shall submit an audit report to the Board of Directors within four weeks after the date of receipt of the numbered items listed under Article 281.1 according to the provisions of Article 280.1.

[2] The audit report mentioned in the preceding paragraph shall include the following matters.

iii. If the balance sheet and the profit and loss statement accurately reflect the situation of the company's assets, profits and losses in accordance with relevant laws and the company's Articles of Incorporation, a statement to this effect.

v. If significant changes were made in the accounting policy with regard to preparation of the balance sheet and the profit and loss statement, a statement to this effect and the reasons.

Approach

In business accounting, it is permissible to choose among a range of options with regard to accounting policies. The Business Accounting Principles state that "the principles and procedures of business accounting shall be applied consistently each year, and these shall not be changed without a proper reason." This is generally called the "principle of continuity." The reason for requiring this principle of continuity is to ensure that the financial statements of different years will be readily comparable and to prevent income manipulation.

Meanwhile, the Commercial Code does not contain any stipulations concerning the "principle of continuity." Naturally, it is not permissible to change the accounting policies for the purpose of manipulating the amounts available for dividends; and from the standpoint of preventing arbitrariness in the preparation of financial statements, other changes in the accounting policies are also basically undesirable.

Therefore, any changes which are made must be intended for the purpose of a more accurate indication of the company's assets, profits, and losses.

A practical example for small and medium businesses would be the recording of expenses up to the limit of loss deductibility under the tax laws, only when there is a profit. This kind of accounting is not permissible.

Monetary claims:

In the valuation of monetary claims, the amount of such a claim must be given. However, if the claim was purchased for a higher price than its amount, its valuation may be increased by a corresponding amount; and if the claim was purchased for a lower price than its amount or there are other suitable reasons, its valuation may be decreased by a corresponding amount. Monetary claims which have a market price may be valued at the current market value.

Net claims and obligations resulting from derivative trading are to be valued at the current market value. However, if these are intended solely as a risk hedge, the derivative are to be valued together with the subject of hedging.

Commercial Code, Article 285-4

[1] Concerning monetary claims, the amount of such a claim must be given. However, if the claim was purchased for a higher price than its amount, its valuation may be increased by a corresponding amount; and if the claim was purchased for a lower price than its amount or there are other suitable reasons, its valuation may be decreased by a corresponding amount.

[3] Notwithstanding the provisions of the preceding paragraph, monetary claims which have a market price shall be valued at the current market value.

Approach

Article 285-4.1 of the Commercial Code states that a monetary claim is to be valued according to its amount, as a general rule. A "monetary claim" refers to a claim for the purpose of a payment of money. This is a broad concept which includes purchase payments, deposits, bills receivable, and accounts receivable.

If the acquisition price of a monetary claim differs from the amount of such a claim, its valuation may be increased or decreased to that level. This kind of procedure is called accumulation/amortization, and it is also recognized under the Business Accounting Standards. For example, the acquisition price could be lower than the amount of the claim because of bill discounting; or the acquisition price could be higher or lower than the amount of the claim because of interest rate adjustment on a negotiable claim.

The Commercial Code states that "monetary claims which have a market price" are to be valued at the current market value. Specifically, this could include commercial paper or negotiable certificates of deposit.

Net claims and obligations resulting from derivative trading are not transferred at the time of their origin, and they undergo significant daily fluctuations in value; so it is appropriate to value them according to their current market value. However, interest rate swaps performed as a hedge on the risk of interest rate fluctuation related to fund raising through bank loans and corporate bonds or fund operation for deposits, securities, etc. do not carry the risk of causing unforeseen losses to the creditors or business connections of small and medium businesses. It is appropriate to value these together with the bank loans, etc. which are the subjects of risk hedging.

Allowance for bad debts:

If it is expected that a monetary claim may be uncollectable, the estimated uncollectable amount must be deducted as an allowance for bad debts. The estimated uncollectable amount is to be valued separately for each claim.

In the case of a special type of group monetary claim, an across-the-board valuation may be made on the basis of past uncollectable debt records and so on, but only if this is appropriate and reasonable.

Commercial Code, Article 285-4

[2] In the case of the preceding paragraph, if it is expected that a monetary claim may be uncollectable, the estimated uncollectable amount must be deducted.

Approach

Under Article 285-4 of the Commercial Code, if it is expected that a monetary claim may be uncollectable, the estimated uncollectable amount must be deducted. The phrase "it is expected that a monetary claim may be uncollectable" in the Commercial Code is interpreted to mean that based on a general consideration of the financial standing of the debtor, the expense and difficulty of collection procedures, and other factors, according to the conventional wisdom of persons related to the business, it is expected that the claim may not be collectable. This expectation is interpreted to refer not only to cases in which an individual judgment is made concerning an individual claim, but also to cases of reasonable judgments concerning all monetary claims, or collectively with regard to a group of the same type of monetary claims.

Next is the issue of the method used to calculate the estimated uncollectable amount. The Commercial Code does not give detailed rules for such methods. The interpretation of the Commercial Code is that as a general rule, calculations are made with regard to individual monetary claims. However, such calculation is also considered to be permissible for specific group monetary claims, so long as this is appropriate and reasonable.

The tax laws contain detailed rules on the methods for calculating bad debt allowances. It is appropriate to choose calculation methods with reference to these rules, staying within the bounds of the rules of the Commercial Code. It is also permissible to use the methods given by the Accounting Standards on Financial Products for calculating the estimated uncollectable amount.

Securities:

The cost method is used as the criterion for valuation of securities. For securities which have a market price, valuation can be performed by the cost method, market value, or the lower of cost or market value. Acquisition cost is evaluated by the gross average method, moving average method, or another generally accepted method.

If the cost method is chosen, and if the market price of a security is significantly lower than its acquisition cost, then unless this difference is expected to be recouped in the future, the security must be valued according to its market value. Securities for trading purposes are valued according to their market value.

Commercial Code, Article 285-5

[1] For corporate bonds, the acquisition price must be given. However, if the acquisition price differs from the amount of the corporate bond, its valuation may be increased or decreased by a corresponding amount.

[2] The provisions of the sentence beginning with "however" in Article 285-2.1, Article 285-2.2, and Article 285-2.3 shall apply to corporate bonds which have a market price; and the provisions of Article 285-2.2 shall apply to corporate bonds which do not have a market price.

[3] The provisions of the two preceding paragraphs shall apply to national and local government bonds and other claims.

Commercial Code, Article 285-6

[1] For shares of stock, the acquisition price must be given.

[2] The provisions of the sentence beginning with "however" in Article 285-2.1 shall apply to shares of stock having a market price. The provisions of Article 285-2.2 and Article 285-4.3 shall apply to shares of stock which have a market price and are not shares of stock in a subsidiary.

[3] Concerning shares of stock which do not have a market price, if the financial standing of the company which issued those shares becomes significantly worse, then the valuation of those shares must be decreased by a corresponding amount.

[4] The provisions of Paragraphs 1 and 3 of this article shall apply to shares held by the employees of a limited company and to other shares held in relation to investment.

Approach

The Commercial Code permits the use of the cost method in the valuation of securities. For securities which have a market price, valuation can be based on the cost method, market value, or the lower of cost or market value.

Small companies, the subject of the current discussion, generally hold very small amounts of securities, if any. Therefore, it is considered that assessment of the market value of securities may be applied in a discretionary manner according to the rules of the Commercial Code.

With regard to securities that are subject to considerable repetitive buying and selling of the same stocks in order to obtain profits due to short-term changes in share prices (securities for trading purposes), using the market value to evaluate the results of such operations is an appropriate way to express the company's financial standing, so it is reasonable to apply the market value.

The Accounting Standards on Financial Products provide detailed rules on the assessment of market value. It is permissible for small and medium companies to use these standards for the assessment of market value as well.

In general, acquisition cost is evaluated by the gross average method or the moving average method. Both of these methods are also recognized under the Business Accounting Standards and tax laws.

Under the Commercial Code, if the cost method is chosen and if the market price of a security is significantly lower than its acquisition cost, then unless this difference is expected to be recouped in the future, the security must be valued according to its market value (applying the rules for liquid assets). The Commercial Code does not provide detailed rules on the meaning of "significantly lower," but based on the views of legislators, the phrase "significantly lower" is to be interpreted as meaning "lower than the normal range of price fluctuations." It is considered that compulsory devaluation should be implemented within the bounds of the rules of the Commercial Code, with reference to rules in the tax laws on decreasing valuation.

Inventory assets:

Either the cost method or the lower of cost or market value method may be used as the criterion for valuation of inventory assets. For the inventory asset valuation method, it is permissible to use the individual method, the first-in first-out method, the last-in first-out method, the gross average method, the moving average method, or another generally accepted method.

If the cost method is chosen, and if the market value of an inventory asset is significantly lower than its acquisition price, then unless this difference is expected to be recouped in the future, the security must be valued according to its market value. The acquisition price of an inventory asset is determined by adding incidental costs, such as acceptance costs, to the purchase price or manufacturing cost.

Commercial Code, Article 285-2

[1] For liquid assets, the acquisition price or manufacturing cost must be given. However, if the market value is significantly lower than the acquisition price, then unless the market value is expected to be rise to the level of the acquisition price or manufacturing cost in the future, the market value must be given.

[2] The provisions of the preceding paragraph shall not obstruct the indication of market value if the market value is lower than the acquisition price or manufacturing cost.

Approach

The Commercial Code recognizes the use of either the cost method or the lower of cost or market value method as the criterion for valuation of inventory assets. The practice of most small companies is to use the cost method.

The Commercial Code does not contain clear rules concerning the method of valuation. However, the valuation methods stipulated in tax laws are generally used.

The sentence beginning with "however" in Article 285-2 of the Commercial Code requires compulsory devaluation if the cost method is chosen. The Commercial Code does not provide detailed rules on the meaning of "significantly lower," but based on the views of legislators concerning interpretation of the Commercial Code, the phrase "significantly lower" is interpreted as meaning "lower than the normal range of price fluctuations," as for securities. It is considered that compulsory devaluation should be implemented within the bounds of the rules of the Commercial Code, with reference to rules in the tax laws on decreasing valuation in the tax laws.

To determine the acquisition cost of products, the direct incidental expenses, such as freight in expenses and purchasing commissions, and indirect incidental expenses, such as clerical costs related to purchasing and acceptance inspection costs, are added to the purchase price. It is appropriate to decide the extent of costs to be included in the acquisition cost by considering the principle of importance and cost-benefit correspondence.

Fixed assets:

Depreciation of fixed assets is conducted in a continuing and regular manner every year under the fixed rate method, the fixed amount method, or another method. Small amounts of depreciable assets may be handled as expenses. If asset value undergoes a significant unforeseeable decline, this loss in value must be deducted.

Commercial Code, Article 34

ii. Concerning fixed assets, the acquisition cost or manufacturing cost must be depreciated by an appropriate amount once every year at a certain time, or in the case of a company, at the time of each closing of accounts; and in the case of an unforeseeable decline in value, corresponding depreciation is required.

Approach

Article 34 of the Commercial Code requires appropriate depreciation of fixed asset at the time of each closing of accounts.

The practice of many small and medium businesses is to conduct depreciation within the bounds of the limit of loss deductibility under the tax laws. Some indicate that they perform depreciation in a discretionary manner according to their business condition. The reasons are the fear of business administrators that if there is a deficit, financial institutions will be very cautious about lending money; and the idea that if there is a carryover loss under tax laws, expensing through depreciation can be left for the future.

Since the current discussion is aimed at financial statements which are desirable for companies that wish to diversify sources of funding and expand business connections, and which are highly reliable for creditors and business connections, it is necessary for depreciation to be conducted under a regular method such as the fixed rate method or the fixed amount method. This does not obstruct the determination of the usable lifetime or selection of a depreciation method for an individual asset according to its nature.

Article 34 of the Commercial Code provides for loss in value of fixed assets. Loss in value is generally interpreted to include both physical loss in value due to disasters, accidents, etc. and functional loss in value in new products, new technologies, etc. However, some kinds of functional loss in value are considered to be foreseeable, and this corresponding devaluation is limited to unforeseeable losses in value. Therefore, foreseeable losses in value are to be included in normal depreciation.

Deferred assets:

Inaugural costs, pre-operating costs, experimentation and research costs, development costs, new stock issuance costs, bond issuance costs, bond discounts, and interest during construction may be recorded as deferred assets.

Commercial Code, Article 286

Payments made under the provisions of numbered items (vii.) and (viii.) of Article 168.1, commissions and compensation paid under the sentences beginning with "however" in those numbered items, and taxes paid for registration of incorporation may be recorded under the assets column on the balance sheet. In this case, if it is determined after company establishment that interest is to be distributed until operations commence, then this must be written off in at least equally divided portions at the time of each closing of accounts within five years after such distributions cease.

Commercial Code, Article 286-2

Amounts paid as pre-operating costs may be recorded under the assets column on the balance sheet. In this case, these amounts must be written off in at least equally divided portions at the time of each closing of accounts within five years after the commencement of operations.

Commercial Code, Article 286-3

Special expenditures for the purposes listed below may be recorded under the assets column on the balance sheet. In this case, these amounts must be written off in at least equally divided portions at the time of each closing of accounts within five years after these expenditures are made.

i. Research on new products or new technologies
ii. Adoption of new technologies or a new management structure
iii. Development of resources
iv. Market development

Commercial Code, Article 286-4

[1] If new stock is issued, the expenses needed for such stock issuance may be recorded under the assets column on the balance sheet. In this case, these amounts must be written off in at least equally divided portions at the time of each closing of accounts within three years after new stock issuance.

Commercial Code, Article 286-5

If corporate bonds are issued, the expenses needed for such bond issuance may be recorded under the assets column on the balance sheet. In this case, these amounts must be written off in at least equally divided portions at the time of each closing of accounts within three years after bond issuance, or if the time of bond redemption is less than three years after issuance, then within that period.

Commercial Code, Article 287

If the total amount to be returned to corporate bond holders is greater than the amount obtained through bond subscription, then the difference may be recorded under the assets column on the balance sheet. In this case, these amounts must be written off in at least equally divided portions at the time of each closing of accounts within the period up to the time of bond redemption.

Commercial Code, Article 291

[1] If it is recognized that the company will not be able to commence full operations within two years after its establishment because of the nature of its business objectives, then a decision may be made in the company's articles of incorporation to distribute interest at a fixed rate to shareholders of certain shares for a definite period of time before the commencement of operations.

[4] Interest distributed under the provisions of Paragraph 1 may be recorded under the assets column on the balance sheet. In this case, whenever interest distributions in one year exceed six percent of the company's total capital, the amount of such excess and at least an equivalent amount shall be written off.

Approach

The Commercial Code recognizes the recording of deferred assets under the seven articles above. "Deferred assets" refers to the recording of expenses as assets when a price has already been paid or a payment obligation has been established, and although services have already been received in return, it is expected that the effects thereof will reach into the future. However, deferred assets do not carry legal rights like intangible fixed assets, and they cannot be sold for cash or used as collateral. Therefore, as a means of protecting creditors, the Commercial Code places limits on the recording of deferred assets. Also, the recording of deferred assets is discretionary. The law requires deferred assets to be written off within a short period of time, in at least equally divided amounts at each settlement of accounts. It also places restrictions on distributions.

The Corporation Tax Law does not allow the simultaneous writing off of the above along with defrayment charges for public facilities and the like, concession money paid to lease assets, concession money paid to receive services, expenses for the conferment of assets used for advertising and publicity, etc. These are called "deferred assets under tax laws." It is appropriate to record these as long-term prepaid expenses.

The Accounting Standards on Research and Development Expenses provide rules related to experimentation and research costs and development costs, but since these may be recorded as deferred assets under the Commercial Code, and since R&D makes up a small proportion of the budget at most small and medium companies, application is considered to be discretionary.

Allowances:

If future expenses or losses are specified, the reason for occurrence of such expenses or losses is an event prior to the current period, there is a high probability of occurrence of such expenses or losses, the amount thereof can be reasonably estimated, and there is a legal obligation, then these expenses or losses must be recorded as allowances or the like. Such expenses or losses are also to be recorded if they are not legal obligations but have a high degree of importance.

Commercial Code, Article 287-2

Allowances prepared for specific expenditures or losses may be recorded in the liabilities column of the balance sheet, not to exceed an amount corresponding to expenses or losses in that business year.

Approach

Article 287-2 of the Commercial Code provides rules on allowances. The items generally called "allowances" are of two major types: valuation allowances (such as a bad debt allowance) recorded under the assets column, and liability allowances recorded under the liabilities column. Liability allowances are further classified as obligatory allowances and non-obligatory allowances.

For a long time there was a debate about allowances under the Commercial Code. However, it is now generally accepted that the allowances provided for under Article 287-2 are liability allowances provided for future payments without a legal obligation.

One specific example would be an allowance for repairs which are not a legal obligation. Since some repair expenses could be extremely costly or otherwise of a high level of importance, it is appropriate to record an allowance for repairs.

It is also appropriate to record allowances and reserves as defined under tax laws as allowances under this article if these are not obligatory and fall under the purpose of this article.

Meanwhile, since allowances that carry a legal obligation (conditional obligations, etc.) are obligations under the Commercial Code, they naturally must be recorded as allowances or unpaid expenses, etc. These include bonus allowances, product warranty allowances, and other legal obligations; and they are to be recorded as conditional obligations, either as liquid liabilities or as fixed liabilities.

Retirement pension allowance and retirement benefit allowance:

If a company has adopted a retirement benefit system with the possibility for additional future contributions, such as internally accumulated lump sum retirement grants, employee pension funds, qualified pension funds, or fixed benefit company pensions, then with regard to that portion of the voluntary payment amounts due at the end of each period which is taken as the present value considering future years of employment and other factors, an allowance for retirement benefits is recorded in accordance with the company's situation, or the amount of the company's retirement benefit obligation minus its pension assets, etc. is recorded.

If a company has adopted a system that will not involve additional future contributions, such as a mutual aid system for retirement benefits of small and medium enterprises, a mutual aid system for specified retirement benefits, or a fixed contribution pension, then the premium paid each year is handled as an expense.

Even if a company has no rules on retirement and no agreement exists concerning the payment of retirement benefits, etc., but it is likely that the company will pay retirement benefits in the future, then an allowance is to be recorded if it is possible to reasonably estimate the relevant amount and this is of a high level of importance.

Approach

Retirement benefit obligations are handled differently depending on the type of retirement benefit system adopted by the company.

Companies that have adopted internally accumulated lump sum retirement grants, employee pension funds, qualified pension funds, fixed benefit company pensions, or other retirement benefit systems based on employment rules, etc. with the expectation for additional future contributions have a legal obligation with regard to their employees, and must record allowances.

In past practice with regard to internally accumulated lump sum retirement grants, the amount recorded for allowances was the entire limit of deductibility under tax laws. (A stepwise decrease began in 1998, from 40% to 20% of the voluntary payment amounts due at the end of each period.) However, with the tax changes of 2002, the retirement benefit allowance system was abolished under the tax laws, and retirement benefit allowances are no longer included under losses. That portion of the voluntary payment amounts due at the end of each period which is taken as the present value, considering future years of employment and other factors, is treated as an index for an appropriate allowance regarding internally accumulated lump sum retirement grants. It is suitable for this to be judged individually for each company.

Concerning retirement when required by the company as well, if it is expected that future payments will be made, then allowances need to be recorded.

With regard to company pension systems, the Fixed Contribution Pension Law was enacted in October 2001 and the Fixed Benefit Company Pension Law was enacted in April 2002. Qualified pension funds will be abolished over the next ten years, and the company pension system is currently in a transition period.

In past practice, the premiums paid each period were handled as expenses. However, if additional future contributions are expected, it is necessary to record allowances in an additive manner.

If a company has adopted a system that will not involve additional future contributions, such as a mutual aid system for retirement benefits of small and medium enterprises, a mutual aid system for specified retirement benefits, or a fixed contribution pension, then the company fulfills its obligation by paying the premium each period. For this kind of company, it is appropriate to handle premium payments as an expense.

If a company has no rules on retirement and no agreement exists concerning the payment of retirement benefits, etc., then the company does not have any legal obligation to pay retirement benefits. Therefore, it is appropriate to handle this in the same manner as allowances under Article 287-2 of the Commercial Code.

Lease transactions:

The ordinary kinds of lease transactions generally conducted by small and medium businesses (finance leases in which ownership of the leased property does not pass to the lessee under the conditions of the lease contract) are handled as rental transactions.

If the circumstances of the lease transaction are actually considered to be the same as the sale of property, then it is handled as a sale transaction, as a general rule.

For small and medium businesses, lease transactions have generally been based on contracts that can be handled by the same accounting procedures as ordinary rental transactions; so they have been handled by the accounting procedures for rental transactions. For a publicly held company, under the Accounting Standards on Lease Transactions, if the economic circumstances are the same as they would be in the case of the sale of the property in question, then the transaction can be handled either by the accounting procedures for rental transactions, with additional information on the leased property provided in an explanatory note; or by the accounting procedures for a sale transaction.

For small and medium businesses, it is appropriate to judge whether a transaction should be handled as a rental based on the content of the contract.

If the amounts paid in lease transactions make up a relatively large proportion compared to the scale of a company's business, then considering the importance of such transactions, it is appropriate to include explanatory notes with information on the lease transactions, to an extent that is sufficient for the interested parties of small and medium businesses.

Recording expenses and revenues:

The revenues obtained by a business over a certain period of time and the expenses spent in order to obtain those revenues must be recorded in a corresponding manner.

As a general rule, expenses are recorded on an accrual basis, while revenues are recorded on a realization basis. Depending on the certainty of obtaining revenues, they may be recorded under any generally accepted method, such as a percentage of completion basis, accumulation basis, or collection basis.

Concerning the acquisition price of various types of assets, those portions corresponding to revenues obtained during the current period are recorded under the expense column of the profit and loss statement, while those portions corresponding to revenues to be obtained after the current period are recorded under the assets column of the balance sheet.

Approach

The Commercial Code does not give any particular rules concerning expenses, revenues, or the criteria for recording them. The Business Accounting Standards use the principle of period matching between expenses and revenues. The recording criteria for recognition of expenses and revenues are to record revenues on a realization basis and expenses on an accrual basis.

With regard to inventory assets, fixed assets, deferred assets, and so on, the acquisition price can be allocated as current period expenses and future period expenses in order to achieve period matching between expenses and revenues. These principles are being used in practice, and they are considered to be appropriate.

Revenues are recorded on a realization basis as a general rule, primarily on a sales basis. However, there may be variation in the time when the uncertainty of revenues is eliminated. If revenues are recorded in the manufacturing process, a completion basis or accumulation basis can be used; while if revenues are recorded in the payment collection process, a collection basis can be used for installment sales. These are also commonly used in practice, and are considered to be appropriate.

The recording criteria for expenses and revenues should be selected according to their respective natures. However, it is not permissible to use different criteria for items which are of the same nature, for the purpose of manipulating the amounts available for dividends.

Deferred and accrued account items:

Prepaid expenses, prepayments received, accrued amounts payable, accrued income, and other deferred and accrued account items need not be handled as deferred and accrued account items if they are of a low level of importance.

Approach

Although the Commercial Code does not provide rules on this subject, the Business Accounting Standards state that prepaid expenses, prepayments received, accrued amounts payable, accrued income, and other deferred and accrued account items must be recorded as anticipatory or deferred profits or losses.

Based on the principle of importance, it is permissible to omit the recording of some deferred and accrued account items. This is considered to be appropriate for items which do not have any major effect on profits.

Note:

Beginning on the next page, we will discuss some matters which are not necessarily required of small companies under the Commercial Code, such as tax effect accounting, cash flow statements, and explanatory note information.

These items are also considered to provide useful information for the creditors and business connections of small and medium businesses. Therefore, we will indicate policies which are more desirable for small and medium businesses that wish to make use of their financial statements to expand business connections or obtain sources of funding.

It is appropriate for each small or medium business to decide on its own whether to use these items, based on its individual circumstances such as the requirements of financial institutions or the cultivation of trust among business connections.

Tax effect accounting:

Tax effect accounting is adopted when necessary for reasons related to financial institutions or business connections, according to the company's situation.

Approach

Tax effect accounting is the use of accounting procedures for appropriate periodic allocation of corporation tax, etc. in the case that differences exist between assets and liabilities under business accounting and assets and liabilities under taxable income calculation, due to differences in the times when profits and losses are recognized under business accounting and under taxable income calculation. Publicly held companies are required to use the Accounting Standards on Tax Effect Accounting.

In the case of small and medium businesses, since their accounting procedures are based on the tax laws, in general these temporary differences are actually very small. Also, since small and medium businesses are subject to a relatively wide range of business fluctuation and the recoverability of deferred tax assets is often not certain, it is frequently judged that this should not be used.

Therefore, although the use of tax effect accounting is not required, it is appropriate for small and medium businesses to use tax effect accounting if necessary for reasons related to financial institutions or business connections.

Cash flow statements:

It is desirable to prepare cash flow statements as a basis for business decisions.

Approach

The preparation of cash flow statements is not required under the Commercial Code. In recent years, businesses have been reminded of the need to emphasize cash flow; but even earlier, small and medium businesses have shown a high level of awareness of cash movements. In particular, since the financial basis of small and medium businesses is weaker than that of large businesses, success in the daily management of funds has been a major management issue. Meanwhile, since it is difficult to manipulate the movements of cash, financial institutions also recognize the importance of indices showing cash flow.

In any case, it is very important in the management of one's own business to have an accurate grasp of the movements of cash; and considering the effectiveness of cash flow statements in building trust among financial institutions and business connections, it is desirable for small companies to prepare cash flow statements as well.

In the past, statements of cash receipts and disbursements have been prepared, and these statements are similar in nature to cash flow statements. If the preparation of cash flow statements would pose a burden to a company on the short term, it is desirable to clearly determine the movements of cash by any other simple method.

Explanatory notes:

Explanatory notes on important accounting policies are not required under the Commercial Code. However, it is desirable to provide such explanatory notes for the convenience of creditors and business connections. Also, considering the characteristics of small and medium businesses, it is desirable to use explanatory notes to provide information on debts and credits between executives and the company, the furnishing of security, the existence of guarantees, and so on.

Commercial Code Enforcement Rules, Article 24 (Reference: The former Rules on Financial Statements, Article 3; the same applies below.)

[1] Explanatory notes shall be included in the balance sheet or profit and loss statement with regard to the major accounting policies used in the preparation of the balance sheet or profit and loss statement, such as the asset valuation method, fixed asset depreciation method, and method of recording major allowance reserves. However, this shall not apply to accounting policies which companies are generally expected to use, such as the valuation methods provided under Article 285-2.1 of the Commercial Code.

[2] If changes are made in the accounting policies related to preparation of the balance sheet or profit and loss statement, then an explanatory note must be included in the balance sheet or profit and loss statement, identifying these changes and the resulting increase or decrease. However, if the changes or the resulting increase or decrease are minor, it is not necessary to include or record them.

Commercial Code Enforcement Rules, Article 27

The explanatory notes to be included or recorded under the provisions of this clause may be omitted with regard to the balance sheets and profit and loss statements of joint-stock companies under Article 22.1 of the Law for Special Exceptions to the Commercial Code (hereinafter "small companies"). However, this shall not apply to the explanatory notes on differences under Article 72, or the explanatory notes on surpluses and net assets under Article 75.

Commercial Code Enforcement Rules, Article 85

[1] In addition to the matters indicated in these rules, the supplementary schedules shall include any important matters needed to supplement the statements or records in the balance sheet, profit and loss statement, and business report.

[2] If the company's policies concerning the preparation of the balance sheet or profit and loss statement are changed, the reasons for such changes shall be indicated in the supplementary schedules. However, this shall not apply if the changes are minor.

Commercial Code Enforcement Rules, Article 86

[1] The following matters shall be included in the supplementary schedules:

i. Increase or decrease in capital and reserves
ii. Increase or decrease in corporate bonds or long-term or short-term loans other than corporate bonds
iii. Details of fixed asset acquisition, disposal, and depreciation cost
iv. Details of security rights established on assets
v. Details of guarantee obligation
vi. Details of allowance reserves, reasons for recording thereof, and method of calculating the balance thereof (unless stated in an explanatory note on the balance sheet)
vii. Details of debts and credits with regard to the controlling shareholder
viii. Details of investment in subsidiaries, and number of company shares held by each subsidiary
ix. Details of credits with regard to subsidiaries
x. Details of transactions with a director, auditor, or controlling shareholder (including transactions conducted by these persons on behalf of a third party) and transactions with third parties that involve a conflict of interest with a director, auditor, or controlling shareholder of the company
xi. In the case of a company other than the type of company indicated in numbered item (i) under Article 10, the amount of property interests paid as compensation or payment for other services to directors (including compensation or payment for other services as an employee, if the director is also an employee) and the amount of property interests paid as compensation

or payment for other services to auditors

[2] The matters indicated under items (v.), (viii.), and (ix.) of the preceding paragraph may be consolidated and noted together if they are of minor importance.

Approach

Article 24 of the Commercial Code Enforcement Rules requires the inclusion of explanatory notes on important accounting policies in the balance sheet or profit and loss statement. Specifically, this is interpreted to mean the criteria and methods used for valuation of securities, the criteria and methods used for valuation of inventory assets, the method of depreciation of fixed assets, the method for handling deferred assets, the criteria for recording allowance reserves, and the criteria for recording expenditures and revenues. However, it is permissible for small companies to omit these explanatory notes.

Meanwhile, the fact is that the creditors of small and medium businesses have a need for explanatory notes on important accounting policies. Therefore, although it is not mandatory under the Commercial Code, it is basically desirable for small and medium businesses to prepare explanatory note information, according to their own circumstances and the needs of interested parties.

All joint-stock companies are required to prepare supplementary schedules which are available for review at any time by shareholders and creditors. The information stated in the supplementary schedules, along with the information mentioned above, is fully appropriate as explanatory note information.

An important category of information concerning small and medium businesses in particular is that of transactions between a company and its executives. In the case of owner-operated businesses, it is often impossible for an outside observer to distinguish clearly between the personal assets of the owner and the assets of the company. For instance, if the business administrator lends funds to his own company, then although this appears as a debt on the balance sheet, the economic reality is very similar to self-owned capital. Under these kinds of circumstances, the inclusion of explanatory note information in the financial statements will allow users to make factual judgments in a way that is advantageous for the small and medium businesses as well. One of the required matters for explanatory notes in the supplementary schedules is "details of debts and credits with regard to the controlling shareholder," but since transactions between executives and the company are a matter of great interest to creditors and so on, it is desirable to include explanatory notes in the balance sheet or profit and loss statement as well.

III. Bookkeeping

Basic Approach to Bookkeeping:

Reliable bookkeeping is important in order to ensure that the accounting ledgers are also reliable. Bookkeeping must be performed in an orderly, clear, accurate, and comprehensive manner. Bookkeeping must also be handled in a timely way.

Commercial Code, Article 32

[1] A merchant must prepare accounting ledgers and balance sheets to indicate the situation of business assets, profits and losses.

[2] Fair accounting practices shall be taken into account in the interpretation of rules concerning the preparation of commercial ledgers.

Commercial Code, Article 33

[1] Accounting ledgers must express the following matters in a orderly and clear fashion.

i. At the time of business commencement and once every year at a certain time, the business assets and their value; or in the case of a company, its business assets and their value at the time of establishment and at the time of each closing of accounts.
ii. Trading and all other matters which affect the business assets.

[2] Balance sheets shall be prepared on the basis of the accounting ledgers at the time of business commencement and once every year at a certain time; or in the case of a company, at the time of establishment and at the time of each closing of accounts.

[3] When balance sheets have been prepared in writing, they shall be compiled or entered in a specially prepared ledger.

[4] When balance sheets have been prepared in writing, they shall be signed by the preparers.

Commercial Code, Article 33-2

[1] Merchants may use electromagnetic records to prepare their accounting ledgers or balance sheets. ("Electromagnetic records" refers to records prepared by electronic means, magnetic means, or other means that can be recognized by human perception, identified for use in computer data processing by order of the Ministry of Justice; the same applies below.)

[2] If electromagnetic records are used to prepare balance sheets under the provisions of the preceding paragraph, the preparers shall take the steps provided by order of the Ministry of Justice in place of a signature on the information recorded in those electromagnetic records.

Commercial Code, Article 35

A court may order a party to a lawsuit to submit commercial ledgers or a portion thereof, by declaration or by official authority.

Commercial Code, Article 36

[1] A merchant shall retain commercial ledgers and important materials related to the merchant's business for ten years.

[2] The period mentioned in the preceding paragraph shall begin at the time when the ledgers are closed.

Approach

This defines the points to be taken into consideration in bookkeeping by small and medium businesses. Accurate bookkeeping is important to ensure the reliability of accounting ledgers, and this sets out the necessary conditions.

Although large businesses and small and medium businesses are not subject to different requirements at the stage of bookkeeping, the reality is that most large businesses are already meeting the above conditions with regard to bookkeeping because they have well-developed accounting departments, functioning internal controls, and external audits. Meanwhile, small and medium businesses generally have few staff members in the area of accounting, and their internal controls may not be functioning effectively. This is an approach to reliable bookkeeping, based on the characteristics of these types of small and medium businesses.

As stated in Article 33 of the Commercial Code, the records in accounting ledgers must be "orderly and clear" so that creditors and other interested parties will be able to obtain a clear understanding of the content of the financial statements. Specifically, understandable methods need to be used for the forms of financial statements, classification of entries, names of account items, ordering of items arranged in lists, and so on.

"Accurate and comprehensive" means that the records must not deviate from the facts, and all of the matters which should be recorded are entered in the ledgers without exception.

The phrase "in a timely way" means that records should be entered in the ledgers promptly after the occurrence of matters which should be recorded. The more such recording is delayed, the greater the likelihood of an error; so it is necessary to record daily transactions in a timely manner.

IV. Disclosure of Financial Statements

Basic Approach to Disclosure of Financial Statements

Financial statements must be published without delay after approval by the regular meeting of shareholders, as provided by the Commercial Code. Considering the needs of the users of financial statements, and in order to diversify sources of funding and expand business connections, it is desirable to take the initiative in publishing more information than is required under the Commercial Code.

Commercial Code, Article 283

[1] The directors must submit the documents listed in the numbered items under Article 281.1 to the regular meeting of shareholders, report on the content of the documents listed in numbered item (iii.) of that paragraph, and obtain the approval of the regular meeting of shareholders for the documents listed in numbered items (i.), (ii.), and (iv.) of that paragraph.

[4] Without delay after approval is obtained under Paragraph 1 above, the directors shall publish the balance sheet or a summary thereof. However, this shall not apply to a company which has made a resolution as provided in the following paragraph.

[5] By a resolution of its board of directors, a company may make the information stated or recorded on the balance sheet available to the general public by electromagnetic means, as provided by order of the Ministry of Justice, without delay after the approval mentioned in Paragraph 1 has been obtained, and for the period of five years from the date on which such approval is obtained.

Approach

Article 283 of the Commercial Code provides for the publication and disclosure of financial statements. All joint-stock companies must either publish this information in a newspaper or official gazette, or make it publicly available on the Internet.

Publication of a company's balance sheet makes it possible to determine its financial standing. This contributes to protecting the interests of the company's creditors and other interested parties, and also reduces the burden (transaction costs) related to prior investigation by third parties which are considering a transaction with the company. Therefore, the publication of reliable financial statements has important advantages for a small or medium business.

In recent years, along with changes in financial structures and transaction structures, financial statements have grown in importance as materials that are used to judge the credit risk and transaction risk of small and medium businesses. Meanwhile, the recent revision of the Commercial Code has made it possible to disclose financial statements over the Internet, producing a significant reduction in cost constraints. In fact, the environment is now in place for small and medium businesses to conduct publication as required under the Commercial Code.

In the case of Internet publication, the Commercial Code states that the financial statements must remain continuously available for five years. To improve the effectiveness of disclosure during that five-year period, if changes in circumstances occur subsequent to disclosure, it is desirable to add supplementary information concerning those changes for the convenience of users.

For small companies under the Commercial Code, considering the needs of a company's creditors, business connections, and other users of financial statements, it is desirable to take the initiative in disclosing more information on the company's financial statements, beyond the extent of publication and disclosure required under the Commercial Code, in order to diversify sources of funding and expand business connections.

However, the efforts of small and medium businesses alone are not enough to bring about the development of new credit and transaction formats based on the reliability of financial statements. The creditors and business connections who will use these financial statements are also expected to acquire the ability to make accurate judgments concerning the significance of the disclosed financial statements. Taking the example of depreciation, a company is required to perform regular depreciation every period in its accounting; but if accounting at small and medium businesses is to have a sound and healthy future, there must be an environment for the users of financial statements to properly evaluate whether it would be better to suspend depreciation in order to record an apparent profit, or to record a deficit while continuing with regular depreciation. It is desirable to consider accounting at small and medium businesses in light of the roles of creditors, business connections, and other users of financial statements, as well as the roles of specialists and so on.