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The Case for Economic and Accounting Dualism: Towards Reconciling the Japanese Accounting System with the Global Trend of Fair Value Accounting

Noriyuki Tsunogaya, Hiromasa Okada, and Chris Patel

Abstract

Over the last thirty years in particular, a number of papers have examined various issues concerning the Japanese accounting system. However, previous research has largely ignored the importance of Japanese contextual factors. As such, the objective of this paper is to develop a holistic theoretical contextual framework for examining the Japanized process of convergence, which aims at integrating the Japanese-specific accounting system with the Anglo-American model, thereby achieving *de facto* (actual) convergence. This framework includes three heterogeneous genealogies, namely, Accounting Monism, Economic Monism, and Economic and Accounting Dualism, and four contextual dimensions, including legal, historical, political, and economic environments. The results show that because Japan has both globalized large-scale capital markets and well-organized related infrastructures, which include financial systems, governance structures, related laws, auditing standards, and standards-setting bodies, it would be futile to adopt International Financial Reporting Standards (IFRS) without reforming these and related facilities and resources. The findings also show that Economic and Accounting Dualism aims at reconciling heterogeneous concepts in accounting practices, such as future and past measurement attributes, asset-liability and revenue-expense based income, *ex ante* and *ex post* income calculation, and information providing role and reconciliation role of financial reporting. Excessive emphasis on Economic Monism and fair value disregards the fact that Japan is undergoing a prolonged, complex, and controversial process for aligning its entire accounting system with IFRS. Importantly, the partial suspension of fair value measurement and the swing-back towards historical cost measurement caused by the recent global financial crisis revealed that fair value is not unconditionally fair. We suggest that social, historical, political, and economic factors cannot be ignored in this rush towards global convergence of financial reporting. We further argue that accounting research can be enhanced by examining the contextual factors in which the uniqueness of accounting system is embedded.

KEYWORDS: fair value, International Financial Reporting Standards (IFRS), Japanese accounting system, accounting regulation, contextual factors

JEL Classification Codes: M40, M41

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1. Introduction

Global convergence of financial reporting can be classified either as *de jure* (technical) or as *de facto* (actual) convergence. *De jure* convergence of financial reporting is applicable at the accounting regulations level, whereas *de facto* convergence of financial reporting is applicable at the accounting practices level (Tay & Parker, 1990; Cañibano & Mora, 2000). Global accounting standards-setting bodies have focused on simplistic approaches such as developing a set of high quality financial reporting standards, rather than addressing controversial issues such as problems associated with languages, translations, cultural influences, and the judgments of professional accountants (Doupnik & Richter, 2003, 2004; Ball, 2006; Doupnik & Riccio, 2006; Patel, 2006). In addition, in spite of the extensive globalization of capital markets, only local markets exist, and there is still no “international market” (Saito, 2010a).

Thus, research topics concerning accounting systems must consider contextual factors of each country, such as social, historical, political, and economic environments (Perera & Baydoun, 2007; Baker et al., 2010; Heidhues & Patel, 2010; Hellmann et al., 2010). The International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB), and other national standards-setting bodies seek to develop a set of high quality standards, and more than one hundred twenty countries have adopted and/or permitted the International Financial Reporting Standards (IFRS). However, we suggest that we cannot ignore the uniqueness of contextual factors of each country in achieving *de facto* convergence of IFRS.

In developed countries, accounting systems that are embedded in the contextual factors of each country are distinguishable into two groups, namely the “Anglo-American model,” which is used in countries such as the UK, the USA, Australia, and Canada, and the “Continental-European model,” which is used in countries such as Germany, France, and Japan (Nobes, 1992; Doupnik & Perera, 2009). However, because of the global convergence of financial reporting, almost all countries have adopted the “Anglo-American model,” which has developed over a long period of time in an environment characterized by investor orientation, common law, separation of accounting and tax schemes, and extensive application of professional judgments. As such, the focus on convergence of financial reporting has strong Anglo-American biases, and it is assumed that the Anglo-American model is superior to other accounting models.

However, instead of applying IFRS unquestioningly, Japan has adopted a more *cautious approach*. In other words, Japan has not applied IFRS directly and uniformly, but has managed to reduce disparities in financial reporting and in other infrastructures. Indeed, the Japanese standards-setting bodies have developed a complete set of accounting and auditing standards, including conceptual

frameworks to compete with IFRS. Because Japan has both globalized large-scale capital markets and related well-organized infrastructures, which include financial systems, governance structures, the Financial Instruments and Exchange Act, the Companies Act, the Corporation Tax Law, auditing standards, and standards-setting bodies, it would be futile to adopt IFRS without adjusting to related facilities and resources.

In Japan a significant reform of accounting standards, called the Accounting Big Bang, commenced in 1997 as part of the Financial Big Bang, the objective of which was to establish free, fair, and global financial markets by accelerating large-scale deregulation and liberalization (Economic Council, 1996). The Big Bang urged simultaneous reforms in related infrastructures, such as the Financial Instruments and Exchange Act, the Companies Act, and the Corporation Tax Law. The accomplishment of the Big Bang resulted in high quality accounting standards. As a result, the European Commission (EC) suggested that Japanese Generally Accepted Accounting Principles (GAAP) is equivalent to the IFRS, which was adopted by the European Union (EU) (EC, 2008). However, optional application of IFRS commenced in Japan from the end of the fiscal year, March 2010, for the consolidated financial statements of listed companies. The *cautious approach*, which aims at reducing disparities in financial reporting and in other infrastructures, will be obliged to change into the adoption approach by the government's decision with regard to the mandatory application of IFRS. According to the original plan, this decision will be made around 2012 and will likely come into effect after 2015 (BAC, 2009).

Over the last thirty years in particular, a number of papers have examined various issues concerning financial reporting systems in Japan (Iino & Inoue, 1984; McKinnon, 1984; Harrison & McKinnon, 1986; Someya, 1989; Arai & Shiratori, 1991; Cooke, 1991; Nobes, 1991; Jiang & Kim, 2000; Singleton & Globerman, 2002; Duangploy & Gray, 2007; Rahman et al., 2010). While previous research provided useful insights, the topic of convergence of financial reporting and the relevant Japanese contextual factors have been largely ignored. As such, the objective of this paper is to develop a holistic theoretical contextual framework for examining the *Japanized* process of convergence, which aims at integrating the Japanese-specific accounting system with the Anglo-American model, thereby achieving *de facto* convergence. This holistic theoretical contextual framework includes three heterogeneous genealogies, namely Accounting Monism, Economic Monism, and Economic and Accounting Dualism, as well as four contextual dimensions, namely legal, historical, political, and economic environments.

Accounting Monism, developed by AAA (1936), Paton and Littleton (1940), and Schmalenbach (1959), relies on the revenue and expense view in which income is calculated by comparing realized revenues and matched expenses during the accounting period. Economic Monism, developed by Canning (1929), AAA

(1957), and Sprouse and Moonitz (1962), is based on the asset and liability view in which income is calculated by changes in net assets at the beginning and end of the accounting period, excluding changes from transactions with shareholders. Economic and Accounting Dualism, developed by Alexander (1950) and Barton (1974), includes both the asset and liability view and the revenue and expense view. This paper also invokes the accounting ecology framework developed by Gernon and Wallace (1995) and applied by Baker et al. (2010), Heidhues and Patel (2010), and Hellmann et al. (2010), which considers historical, social, political, organizational, professional, individual, and accounting environments of each country.

Based on this holistic theoretical contextual framework, this paper provides rigorous insights into contextual factors that differentiate the Japanese accounting system from the Anglo-American model. This paper rejects the simplistic assumption that Japan has adopted the *cautious approach* because it is too conservative. The Japanese *cautious approach* differs significantly from conservative measurement models proposed by international accounting research (Gray, 1988; Nobes, 1992; Doupnik & Perera, 2009). Compared to countries such as the EU and Australia, which rushed towards IFRS in 2005, Japan is currently undergoing a prolonged, complex, and controversial process for aligning its entire accounting system with IFRS. We use the example of Japan to show that changes do not occur in a vacuum and that contextual factors have a critical influence on the convergence process in individual countries.

The remainder of this paper is organized as follows. Section 2 summarizes traditional frameworks by reviewing previous articles and defining the three heterogeneous genealogies, namely Accounting Monism, Economic Monism, and Economic and Accounting Dualism. Section 3 develops a holistic theoretical contextual framework that includes historical, political, and economic factors. Section 4 applies this holistic theoretical contextual framework for examining the unique characteristics of the Japanese accounting system that cause problems with convergence of IFRS. Section 5 concludes the paper by summarizing the *Japanized* process of convergence of financial reporting.

2. Traditional Framework

2.1 Accounting and Economic Perspectives

Two major perspectives have influenced accounting research and practices, namely the “Accounting perspective” (Accounting income) and the “Economic perspective” (Economic income).¹ The former is past-oriented and forms the basis

¹ In a broad sense, accounting income includes economic income. However, this paper uses the

for *pure* historical cost accounting (HCA), whereas the latter is future-oriented and forms the basis for *pure* present value accounting (PVA). Figure 1 shows the relationship between these confrontational perspectives based on accounting concepts, which include the definitions of the elements of financial statements, measurement attributes, and income concepts. This paper applies these perspectives to the following literature review.

Figure 1 - Accounting and Economic Perspectives

Firstly, Paton and Littleton (1940, p.16) state:

The concepts of recorded price-aggregate, of cost attaching, of matched cost and revenue, and of income as a difference are fundamental to accounting without being necessarily of equal importance in general economic reasoning.... “cost” and “expense” mean cash disbursed, and “revenue” and “income” mean cash received.

According to Paton and Littleton, cost, income, and cash receipt and payment concepts are different in each perspective. In addition, the accounting perspective emphasizes *enterprises* and *actual* facts, whereas the economic perspective emphasizes *markets* and *future* issues. Littleton (1953, p.217) also explains:

An economic point of view attributes high importance to estimates of the future, or to present day costs (because these are considered necessary knowledge for anyone who must judge values or plan for the future); a business or accounting point of

term “economic income” to relativize traditional “accounting income.” The concept of “economic income” as developed by accounting researchers is not necessarily the same as “income” as developed by economists such as Fisher and Hicks. Economists do not refer to it as *economic income*, but as *income*. Accounting researchers use “economic income” for business income, while economists use “income” for individual income. This paper focuses on income not from an economics perspective but from an accounting perspective.

view lays stress upon past invested costs (because these are objective, verifiable facts relevant to this enterprise and to the judgment decisions of its management).

In this regard, Black (1980, p.20) clarifies the features of each perspective as follows:

Economists... usually say that earnings should be related to change in value, and this view has lately been gaining acceptance among accountants. The move to include gains and losses due to changes in currency values in full in the earnings statement for the year in which they occur represented acceptance of the economist's view of value. It was soon discovered, however, that inclusion made a firm's earnings figures more erratic and less useful as a measure of how the firm was doing.

As noted above, the focus of the accounting perspective is oriented toward *past* and *activities*, whereas that of the economic perspective is oriented toward *future* and *prediction*. Although the two perspectives seem opposite, some researchers have tried to integrate their respective features in Economic and Accounting Dualism. Edwards and Bell (1961, p.1) explain:

The suggestion that accounting and economics are related sciences is not a new one. Both are intimately concerned with the activities of the business firm, and in this context both deal with similar variables and their impact on profit. Yet the difference in time perspective which distinguishes the two sciences from each other has served also to keep them further apart than logic would suggest.... It is our contention that this difference in time perspective, far from being a divisive factor, provides the principal relationship between accounting and economics.

Boulding (1977, p.93) also attempts to explain this issue:

[E]ven the accountant's calculation of profit is essentially based on some expectations about the future. Profit is not simply a matter of past performance; it always has in it an element of future expectation. This is because profit depends upon revaluations, and these revaluations may have to be made in the light of changes in expectations in the future.

The above two citations claim that the accounting and economic perspectives would have a complementary relationship.² This relationship is illustrated as follows, “Accounting income (realized income) plus Unrealized income minus Recycling amount plus Increase in goodwill, which is equal to Economic income” (Alexander, 1950; Solomons, 1961; Barton, 1974), where accounting (or realized) income means the measure of income generated by a pure historical cost method under Accounting Monism. In simple terms, this relationship is explained as follows, “Accounting income (realized income) plus all other unrealized increase in values minus Recycling amount, which is equal to Economic income.” Recycling or reclassification adjustment (hereinafter called “Recycling”) is necessary to avoid double counting unrealized income items that are recognized as a portion of realized income during a period and also as a portion of unrealized income in that period or earlier periods. It is important to note that accounting income is a multisense word and not necessarily synonymous with earnings, realized income, or net income. In addition, earnings do not include cumulative accounting adjustments, and therefore earnings are different from realized income and net income (FASB, 1984).

2.2 Genealogy of Accounting Monism

Literature concerning accounting and economic perspectives reveals that there are three heterogeneous genealogies: Accounting Monism, which emphasizes a process of allocation instead of valuation (AAA, 1936); Economic Monism, which has a feature of colonization of accounting by economics (Mouck, 1995); and Economic and Accounting Dualism, which represents a compromise between accounting income and economic income (Solomons, 1961).

Accounting Monism contains a *pure* HCA model, or a *pure* revenue and expense view, which does not include the measurement principle of the lower of cost or market in its structure. Accounting Monism can be understood as a reaction to the accounting frauds and abuses from the 1920s to the 1930s. In that period, asset revaluation was largely practiced in the USA, which permitted companies to recognize earned surpluses by increasing the book value of assets. This was an unsound accounting practice. Amortization of goodwill, write-down of unrecoverable assets, and any other losses were charged to the surpluses. By recognizing artificial surpluses, companies created retained earnings and used them as a resource of dividends (Saito, 1984, 1995).

These upward revaluation practices in the USA contributed to the problem during the Great Depression. As such, the U.S. Securities and Exchange

² Accounting information is an important *input* needed for decision-making in a disequilibrium economy with imperfect and incomplete markets. This aspect of accounting information relates to a feature of the economic perspective (Sorter, 1974; Black, 1980; Whittington, 1983).

Commission (SEC) advocated a stronger focus on conservative HCA. Indeed, after establishing the Securities Act in 1933 and the Securities Exchange Act in 1934, R. E. Healy, one of the five founding SEC commissioners, expressed serious concern about the application of asset revaluation practices. Healy and other like-minded commissioners succeeded in instilling an aversion to upward departures from historical cost (Zeff, 2007a). Importantly, asset revaluation practices disappeared by the 1940s.

This focus on *pure* HCA was further reinforced by the American Accounting Association's study entitled, *A Tentative Statement of Accounting Principles Affecting Corporate Reports*, prepared mainly by E.L.Kohler, H.C.Greer, G.A.MacFarland, A.C.Littleton, and J.B.Taylor (AAA, 1936). The study specifically concluded that accounting is not essentially a process of valuation, but rather the allocation of historical costs and revenues to the current and succeeding fiscal periods (AAA, 1936).

Paton and Littleton (1940) also asserted the importance of *actual* transactions performed by a corporation and *actual* business activities. Because business activities continue year in and year out, accounting must yield periodical results by matching revenues with related expenses. Revenue represents a financial expression of accomplishments, and expense represents a financial expression of related efforts. Income is calculated through a periodical matching process, and the balance sheet shows a carrying amount that is not applicable to the income calculation. As such, the balance sheet "stands as a connecting link joining successive income statements into a composite picture of the income stream" (Paton & Littleton, 1940, p.67).³ Moreover, the lower of cost or market method and the application of market value are rejected because these are neither *actual* nor *verifiable* transactions. Instead of applying these methods, a parenthetical showing of the amount of the estimated difference between cost and market value is recommended if such an amount is substantial (Paton & Littleton, 1940).

In a nutshell, Accounting Monism has two major features. First, Germany and France, together with the USA, abandoned the previous market value approach that had emerged in the nineteenth century and early twentieth century for preventing fraudulent bankruptcy and unsound upward revaluation practices (Biondi & Suzuki, 2007; Zeff, 2007a). Second, because accounting places the estimated market value that is not related to business activities on the back burner,

³ Together with Paton and Littleton (1940), Schmalenbach (1959) relied on the concept of revenue and expense in the calculation of periodical income on the basis of cash receipts and payments. In this income calculation system, assets are largely defined as "payments not yet recognized as expenses," and the balance sheet serves to aid the calculation of operating results by means of the accommodation of profit and loss items in suspense. Schmalenbach (1980) opposed revaluation practices and explained that the revaluation practices for fixed assets contravene the basic principle of good accounting because the result is thereby disguised.

realized income, which is calculated from the perspective of the entire entity as a result of *actual* transactions, becomes a major performance measure for various stakeholders.

2.3 Genealogy of Economic Monism

Canning (1929) defined realized income as the difference between the present values at the beginning and end of the accounting period. This definition of realized income is completely different from net income under the revenue and expense view, in which income is defined as the difference between realized revenues and matched expenses. Canning (1929, p.22) defined an asset as “any future service in money or any future service convertible into money... the beneficial interest in which is legally or equitably secured to some person or set of persons.” Consistent with this definition of an asset, present value was applied as the desirable direct valuation. However, when present value could not be measured with sufficient reliability, indirect valuation, including historical cost measurement, was used as its surrogate. Importantly, direct and indirect valuations implied the relationship between the principle and its surrogate (Canning, 1929).

AAA (1957, 1964a, 1964b) propounded service-potentials as the definition of an asset, present value as its ideal measurement basis, and historical cost or other valuation methods as its surrogate or practical approximation. Significantly, the concept of service-potentials has two distinct dimensions. One concerns the actual monetary *exit* or expenditure capitalized, which is the accounting definition of assets (Biondi, 2007). Indeed, Paton and Littleton (1940), who developed the revenue and expense view, used the concept of service-potentiality as a nature of assets. The other dimension refers to the future monetary *entries*, namely the ability to provide future service or generate future cash flows, which is the economic definition of assets (Biondi, 2007). In the latter case, an asset is measured on the basis of prediction and has a hypothetical nature. AAA (1957, 1964a, 1964b) defined assets as the ability to generate future cash flow, which corresponds to the economic definition of assets.

Moreover, AAA (1957) asserted that the essential meaning of realization is that a change in assets or liabilities becomes sufficiently definite and objective to warrant recognition in accounts. Traditionally, the concept of realization has three requisites: (a) objectivity of measurement attributes, (b) existence of market transactions of goods or services, and (c) acceptance of cash or a claim to cash or other assets (Hendriksen & Breda, 1992). AAA’s (1957) concept of realization meets only the first requisite, which implies that the traditional concept of realization was in retreat in the AAA’s view.

Sprouse and Moonitz (1962) proposed future economic benefits as the definition of an asset, present value as its ideal measurement basis, and net

realizable value and replacement cost as its surrogate. They asserted that profit is a function of an increase in the net assets of the business entity. In addition, Sprouse and Moonitz (1962, p.15) stated that “We will use the term (realization) occasionally because its use is so deeply embedded in accounting terminology, but we cannot accept it as an essential feature of accounting because the concept lacks analytical precision. Instead, our concern is with the real elements, the changes in assets and debts, and the related (derived) effect on profit” (first parentheses added). As such, income is defined from the changes in net assets, and the concept of realization is not given much importance in their theory. These features are consistent with those of Economic Monism.

Under present accounting standards, the concept of realization is used as a basis for revenue recognition, and mixed attributes are applied as the measurement bases for assets and liabilities.⁴ Self-generating goodwill is not recognized without qualification. In contrast, under Economic Monism, (a) the traditional concept of realization is in retreat, (b) the concept of future economic benefits is included in the definition of assets, (c) present value is deemed to be an ideal measurement basis, and net realizable cost, replacement cost, and historical cost are considered as its practical surrogate, and (d) self-generating goodwill is recognized on the balance sheet (see Figure 2).

Figure 2 - Features of Economic Monism

Note: In Economic Monism, service-potentials refer to future monetary *entries*, namely the ability to provide future service or generate future cash flow. Therefore, the definition of assets includes self-generating goodwill.

⁴ Prior to May 2005, the IASB and the FASB planned to move toward a single revenue recognition model that is consistent with Economic Monism. In this so-called fair value model, performance obligations should be measured at the price that the reporting entity would have to pay an unrelated party to assume legal responsibility for performing all of its remaining obligations (FASB, 2011). However, criticisms against that proposal forced these boards to return to the so-called customer consideration model that is consistent with the concept of realization and mixed attributes approach under Economic and Accounting Dualism. In this customer consideration model, performance obligations would be measured at the transaction price (FASB, 2011).

2.4 Genealogy of Economic and Accounting Dualism

Economic and Accounting Dualism aims at arranging, reconciling, and fusing heterogeneous perspectives. To analyze the genealogy of Economic and Accounting Dualism, the following paragraphs refer to several typical views that invoke the Hicksian economic theory, thereby clarifying that accounting and economic perspectives complement each other even though they function separately.

Hicks (1946, p.173) defined “Income No. 1” as “the maximum amount which can be spent during a period if there is to be an expectation of maintaining intact the capital value of prospective receipts (in money terms).” Some researchers seek the logic of comprehensive income under the asset and liability view for this Hicks’s income concept (Schipper & Vincent, 2003; Bullen & Crook, 2005). However, in order to regard Hicks’s income as objective and context-neutral, strictly defined conditions are required. In Hicks’s words, it is the condition of “leav(ing) out of account any increment or decrement in the value of prospects due to changes in people’s own earning power” (Hicks, 1946, p.178, parentheses added). It is only complete markets that fulfill such conditions (Bromwich, et al., 2005, 2010; Fukui, 2007). In other words, it is the case that windfalls do not need to be considered (Saito, 2007). As such, Hicks assumed a more realistic case in which the rate of interest is expected to change. In particular, Hicks (1946, p.174) defined “Income No. 2,” which is a closer approximation to the central concept than “Income No. 1,” as “the maximum amount the individual can spend this week, and still expect to be able to spend the same amount in each ensuing week.”

To gain further insights into Hicks’s income concepts, it is important to examine the primary difference between “Income No. 1” and “Income No. 2.” In fact, “Income No. 1” is better explained by the so-called asset and liability view because this definition of income is derived from the changes in capital values, which are calculated by discounting future cash flows at a fixed rate of interest. In contrast, “Income No. 2” is consistent with the so-called revenue and expense view in the sense that this definition of income is expressed in terms of maintainable, permanent, or sustainable income (Bromwich, et al., 2005, 2010; Fukui, 2007). Importantly, Hicks excluded windfall gains from a conduct-related income and stated as follows, “The income which is relevant to conduct must always exclude windfall gains; if they occur, they have to be thought of as raising income for future weeks (by the interest on them) rather than as entering into any effective sort of income for the current week” (Hicks, 1946, p.179).

As such, in Hicks’s theory, windfalls are excluded in the calculation of a conduct-related income. In fact, what was on Hick’s mind was a permanent income or a sustainable income level, which is better explained by the revenue and expense view, when the rate of interest is expected to change (Fukui, 2007). The evidence

demonstrates that Hicks's theory provided insights into heterogeneous income concepts such as the asset and liability view and the revenue and expense view, which complement each other in different circumstances and conditions (Bromwich, et al., 2005, 2010; Fukui, 2007).

Consistent with Hicks, Alexander (1950, p.1) defined income as follows, "A year's income is, fundamentally, the amount of wealth that a person, real or corporate, can dispose of over the course of the year and remain as well off at the end of the year as at the beginning." Economic income can be designed to fit the case in which complete markets exist and windfalls do not need to be considered. However, once economic income is applied in incomplete markets and windfalls are considered, economic income includes not only the actual increase of wealth resulting from efforts, but also the change in value resulting from luck or a lack of luck. In Alexander's (1950) theory, the former element is called "variable income" and implies "planned income," whereas the latter element is called "unexpected gain or loss" and implies "unplanned income."⁵ As such, in incomplete markets, economic income consists of two distinct elements in the following formula:⁶

(Mixed) Economic income = Variable income + Unexpected change

Where: Variable income = Accounting income (realized income)
+ Expected change in goodwill (going value)

Unexpected change = Unrealized change in tangible assets
(unrealized income) + Unexpected change in
goodwill (going value)

By transforming and organizing the above formula, we derive the following:

⁵ Alexander (1950) classified changes of wealth into two distinct elements, namely planned (effort-based) and unplanned (uncertainty-based) elements. In contrast, the pure logic of HCA focuses on the process of creation and allocation of resources within the enterprise based on the theory of the specificity and complementarity of assets. As such, HCA represents more dynamic aspects of business activities in which no reference to wealth or net worth is required (Bignon et al., 2009; Biondi, 2011).

⁶ In Alexander's (1950) theory, the concept of realization is applied also to financial assets. Indeed, Alexander (1950, p.54) explained that "profit can creep in *only* in a transaction in which an asset is exchanged for more cash than the cost of the asset" (*italics added*). This claim suggests that unrealized change in financial assets should not be recognized as a component of accounting income or variable income as with the case of tangible assets. This treatment is consistent with *pure* HCA, Accounting Monism, and the entity viewpoint. Therefore, although Alexander (1950) did not mention the treatment of change in (financial) liabilities, unrealized changes of (financial) liabilities would not be included in accounting income or variable income as with the case of (financial) assets.

(Mixed) Economic income = Change in tangible assets + Change in goodwill

Where: Change in tangible assets = Accounting income (realized income)
+ Unrealized change in tangible assets
(unrealized income)

Change in goodwill = Expected change in goodwill
+ Unexpected change in goodwill

It is uncertain whether Alexander assumes a specific definition of assets. However, Solomons, the inheritor of Alexander's theory, directly adopts "value to the owner" or "value to the business." Moreover, Baxter, who also belongs to the same school of thought, adopts "deprival value." Historically, Bonbright (1937) asserts that the value of a property to its owner is identical in amount with the adverse value of entire loss that the owner might expect to suffer if he or she were deprived of the property. This is not the same as the accounting definition of assets, which implies actual monetary *exit* or expenditure capitalized. Furthermore, because deprival value adds importance to the hypothetical *exits* of money incurred to secure property or to cover the loss in question, it is in marked contrast to the economic definition of assets, which implies future monetary *entries*. Interestingly, although Bonbright (1937) insisted on the concept of deprival value, he claimed Accounting Monism when the institutional determination of business income, especially with regard to the calculation of distributable and taxable income, is concerned (Biondi, 2011). Specifically, Bonbright (1937) mentioned the reasons for legal rules forbidding the payment of unearned (unrealized) dividends from the viewpoint of creditors' protection.

Barton (1974) also asserted that investors in business enterprises are interested in prospects of future income from investments, namely the *ex ante* income (economic income). When subjective goodwill, which is the difference between the present value and the market value (or initial acquisition cost), is maximized, profit maximization is attained. Therefore, a firm aims at maximizing the net present value of its prospective stream of profits. However, because present value and economic income are subjective and difficult to measure, substitute measures such as replacement costs need to be implemented for practical reasons (Barton, 1974).

As such, according to Barton (1974), economic income is necessary as *ex ante* income. However, the importance of economic income and of adopting replacement costs as surrogates for present values are different dimensions. Economic income and accounting income should be understood not as surrogates, but as reconciliation relationships (Barton, 1974). Economic income evaluates expectations that have not yet occurred, whereas accounting income measures achievements until the end of an accounting period. Thus, Barton's view is characterized by Economic and Accounting Dualism, which plans the

reconciliation of the economic perspective (*ex ante* planning) with the accounting perspective (*ex post* control).

Briefly, Economic and Accounting Dualism has two major features. First, Dualism emphasizes the heterogeneous income such as realized and unrealized income as well as *ex post* and *ex ante* income. Second, the change in goodwill is a crucial concept for bridging the gap between accounting income and economic income.

2.5 Limitations of Traditional Framework

Accounting Monism relies on the revenue and expense view in which income is calculated by comparing realized revenues and matched expenses during the accounting period. Economic Monism is based on the asset and liability view in which income is calculated by changes in net assets at the beginning and end of the accounting period, excluding changes in capital transactions. Economic and Accounting Dualism includes both the asset and liability view and the revenue and expense view. As long as heterogeneous concepts exist in contemporary accounting standards, Dualism provides some insights into the present positions of the IASB, the FASB, and the Accounting Standards Board of Japan (ASBJ).

However, the traditional framework, which considers only Accounting Monism, Economic Monism, and Economic and Accounting Dualism, cannot fully explain the fact that accounting income is still a worthwhile measure in contemporary accounting. In other words, the traditional framework cannot adequately explain why Accounting Monism was replaced by Economic and Accounting Dualism. Indeed, the IASB and the FASB are now obliged to adopt Dualism even though Economic Monism is a driving force in the global convergence of financial reporting.

Briefly, the traditional framework provides some useful insights into issues such as controversial measurement and recognition bases in each country. However, this framework cannot fully explain the complexity of the unique environment in each country and ignores the importance of social, historical, political, and economic factors in the evolving nature of accounting in the globalized world.

3. Holistic Theoretical Contextual Framework

3.1 Necessity of Framework Development

We argue that accounting research can be enhanced by analytically examining the social, historical, political, and economic factors in every country instead of focusing only on measurement and recognition issues. We argue further that global

convergence of financial reporting is a complicated and moving target in the realistic sense. Indeed, no matter how extensively capital markets are globalized, no “international market” exists apart from local markets. Therefore, the rules, which are newly established in local markets, entail continuous and complex adjustment processes (Saito, 2010a).

Figure 3 - Holistic Theoretical Contextual Framework

Notes: *1 Accounting practices are defined within the domain of Accounting Monism and Economic Monism.
 *2 Political vector towards fair value and/or present value measurements is driven by the IASB and the FASB.
 *3 Swing-back towards historical cost measurement by recent financial crises.
 *4 The IASB, the FASB, and the ASBJ have adopted Economic and Accounting Dualism at present.

The accounting ecology framework developed by Gernon and Wallace (1995) describes five separate but interacting slices, namely the social,

organizational, professional, individual, and accounting slices. These five slices can be defined as follows. First, the social slice refers to structural, demographic, and cultural elements that may affect the demand for financial accounting services. Second, the organizational slice encompasses such elements as organizational size, technology, complexity, culture, and human and capital resources that may affect rationalizations in the choice and design of accounting systems. Third, the professional slice refers to the education, training, registration, discipline, and ethics of accountants and auditors. Fourth, the individual slice refers to accounting policy choices made by individuals and covers the total setting in which reporting enterprises, professionals, and other individuals lobby standard setters to pursue their self-interests. Finally, the accounting slice refers to accounting practices, rules, and/or trends that affect or are affected by other slices of the environment (Gernon & Wallace, 1995).

Heidhues and Patel (2010) extend this framework by proposing that international accounting research may be further enhanced by taking into account contextual factors such as political, legal, social, and historical factors. In particular, they invoke this framework to provide additional insights into the factors differentiating the German accounting model from other accounting models, such as the conservative nature of accounting practices and the importance of merchants' privacy in Germany. Importantly, this framework is also applied by Perera and Baydoun (2007), Baker et al. (2010), and Hellmann et al. (2010) to clarify the unique features of accounting systems in Indonesia, China, and Germany respectively.

Based on this framework, this paper develops an innovative framework for comparing the Japanese accounting system with IFRS and the Anglo-American model. Figure 3 shows the following: the four contextual dimensions, namely legal, historical, political, and economic environments, which define accounting standards and practices; and the three heterogeneous genealogies, namely Accounting Monism, Economic Monism, and Economic and Accounting Dualism.

3.2 The Japanese Legal System: A Triangular Legal System

Three laws, namely the Financial Instruments and Exchange Act (formerly the Securities and Exchange Law enacted in 1948), the Companies Act (formerly the Commercial Code enacted in 1890), and the Corporation Tax Law (enacted in 1947), have considerable effect on the accounting practices in Japan. These laws relate organically to each other. This unique style of accounting regulation is called the "triangular (legal) system."

The objective of the Financial Instruments and Exchange Act is to aid strong development of the national economy by providing useful information for investors (Article 1). The law entrusts accounting standards-setting bodies, such as

the Business Accounting Council (BAC) and the ASBJ, with the development and/or revision of accounting standards. According to *Discussion Paper: Conceptual Frameworks of Financial Accounting* (ASBJ, 2006a), the objective of financial reporting is to measure and disclose the position and the performance of an entity's investments to support investors' decision-making (ASBJ, 2006a). In addition, as a secondary use, accounting information is used for the calculation of surplus available for distribution, the calculation of taxable income, and the calculation of financial ratios such as gearing ratio and solvency margin ratio (ASBJ, 2006a).

With regard to provisions for accounting, the principal objective of the Companies Act is to reconcile stakeholders' interests and protect creditors through the calculation of the surplus available for distribution.⁷ When shareholders' liability is limited, the assets of a company are regarded as the only available resource for settling creditors' claims. If a company distributes unrealized income, it cannot maintain this resource for the creditors and reconciliation of interests cannot be accomplished. Hence the Companies Act prescribes the maximum amount of the surplus available for distribution in order to avoid over-outflow of resources from a company (Article 461-2).

The Corporation Tax Law also influences accounting practices in Japan. Its principal objective is the fair calculation of the taxable income. In principle, net income is used as the basis for calculating taxable income. The Corporation Tax Law allows corporations to deduct only those expenses that are included in income calculation according to the Companies Act and settled in the general meeting of shareholders (Articles 2-25, 74-1). If a company has an alternative to select one among several accounting methods or if accounting methods are not specified in other accounting standards, the company inevitably adopts the one prescribed by the Corporation Tax Law in order to achieve tax savings. These rules are called "the principle of recognizing as expense (*Sonkin Keiri Youken*)" and "the principle of definite settlement of accounts (*Kakutei Kessan Syugi*)."⁸ These principles originate from "the authoritative principle (*Maßgeblichkeitsprinzip*)" adopted in Germany, which basically defines the financial statements as the basis for taxation. In particular, the tax balance sheet is prepared according to the principles of orderly accounting of the German Commercial Code (*Handelsgesetzbuch: HGB*) if there are no opposing tax rules (Hellmann et al., 2010).

⁷ Although some adjustments are required, under the Commercial Code retained earnings were the only source of the *income* available for dividends. However, the Companies Act prescribes the *surplus* available for distribution and allows distribution not only from retained earnings, but also from other capital surplus, which is the accumulated amount accrued in the case of capital and capital surplus reduction (Article 446). This revision resulted from the relaxation of regulations to pursue the minimization of shareholders' equity.

Even in double-reporting (disconnected) regime countries such as the UK and the USA, where accounting standards and tax laws are highly independent, taxable income is more or less based on GAAP. The main difference between Japan and such double-reporting regime countries is the extent to which “the principle of recognizing as expense” and “the principle of definite settlement of accounts” have permeated these accounting practices. Japan has adopted a single-reporting regime in which accounting standards and tax laws have been highly dependent. Thus, the belief that these principles need reexamination is encountered, especially for listed companies’ consolidated financial statements. This opinion is supported by the claim that consolidated financial statement should be revised quickly to reflect revisions of IFRS. Non-consolidated financial statements should be revised after finishing domestic reconciliation with other systems, including distinctive trade practices, traditional accounting practices, the Companies Act, and the Corporation Tax Law (BAC, 2009). In contrast, opinions that these principles should be maintained are deeply entrenched, especially regarding the preparation costs for small and medium-sized enterprises’ financial statements (JICPA, 2010).

Based on the triangular legal system, the Japanese accounting system maintains two major roles concerning financial reporting. One is the information providing (informational) role, namely providing decision-useful information for investors. The other is the reconciliation (stewardship) role, namely reconciling interests among stakeholders (Ijiri, 1967). Global convergence of financial reporting, led by Anglo-American countries, relates almost entirely to the information providing role of financial reporting. For achieving the information providing role, the *future*-oriented economic perspective is becoming the preferred choice. However, under the Japanese triangular legal system, the *past*-oriented accounting perspective is still required for the calculations of surplus available for distribution and taxable income, thereby achieving the reconciliation role of financial reporting. As such, it is necessary to seek the *Japanized* process of convergence in line with Economic and Accounting Dualism, which includes both the information providing role and the reconciliation role.

3.3 Historical Development: Lessons from the USA

To provide historical insights into recent debates on the global convergence of financial reporting, this section provides outlines on the development of accounting standards in the USA in the following five steps: (a) application of a *pure* HCA that does not accept revaluation practices; (b) introduction of the lower of cost or market method for inventories and certain financial instruments; (c) application of inflation-related supplementary disclosure for the cost of goods sold, inventories, and fixed assets; (d) partial adoption of fair value measurement for financial instruments and additional disclosure for such items; and (e) adoption of

impairment accounting for long-lived assets (See Figure 4). Because the USA has influenced the Japanese accounting system, the case of the USA provides valuable lessons for Japan.

Figure 4 - Historical Cost Accounting (HCA) and Fair Value Accounting (FVA)

Notes: Solid arrows: actually experienced courses, Dashed arrows: future possible courses

*1 1920s–1940s: Asset revaluation movements

*2 1940s–1970s: Enforcement of the lower of cost or market method for inventories and certain securities

*3 1950s–1980s: Influence of inflation on accounting standards

*4 1980s–1990s: Influence of financial crises on savings and loan mutual banks

*5 1990s: Introduction of cash inflow perspective and fair value measurement for long-lived fixed assets

*6 1990s–2000s: Development of financial economy and financial technology

*7 2000s: Swing-back by the recent financial crisis

*8 Comprehensive fair value measurement for all assets and liabilities

*9 Recognition of all intangibles including self-generated goodwill

First, the lesson of *unsound* upward asset revaluation practices from the 1920s to the early 1930s influenced the SEC to change its position completely and

establish a *pure* HCA model that does not allow the lower of cost or market method (Saito, 1984, 1995; Zeff, 2007a). According to the definitions given in this paper, only this first step corresponds to Accounting Monism. The following second to fifth steps correspond to Economic and Accounting Dualism because some reconciliation of the accounting and economic perspectives are considered in these steps.

The second step was based on the fact that accounting practices permitted the lower of cost or market method for inventories and certain financial instruments. HCA that involves the lower of cost or market method, so-called *modified* HCA, was then advocated. Significantly, even after permitting the lower of cost or market method (AIA, 1947; FASB, 1975), the SEC did not change its position and rejected upward asset revaluation. Indeed, the American Institute of Accountants (AIA), which took on the authority to establish U.S. GAAP from the SEC, attempted in 1950 to prepare an Accounting Research Bulletin (ARB) on “quasi-reorganization” that allowed asset revaluation and depreciation based on its increased value. However, the SEC did not permit the ARB (Zeff, 2007a).

Third, in order to deal with the inflation from the 1950s to the 1970s, the SEC was compelled to issue *Accounting Series Release (ASR) 190: Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data* (SEC, 1976), which required replacement cost disclosures for the cost of goods sold, inventories, and fixed assets. Because the FASB issued the *Statement of Financial Accounting Standards (SFAS) 33: Financial Reporting and Changing Prices* (FASB, 1979), which required more comprehensive supplementary disclosure, including both current cost and general price-level data, *ASR 190* was superseded by *SFAS 33*. However, contrary to expectations, this supplementary disclosure was not supported by investors because of a lack of relevance and reliability (Sakurai, 1991). As a result, the FASB was obliged to release *SFAS 89: Financial Reporting and Changing Prices* (FASB, 1986), as a replacement for *SFAS 33*, in which the requirement retreated to voluntary disclosure. The significant fact is that not HCA, but fair value disclosure was denied, even during the period of inflation.

Fourth, the crisis of savings and loan mutual banks in the 1980s created the momentum to criticize HCA. The main objections against HCA were that: (a) loss recognition for unrecoverable mortgage loans was postponed, and (b) gain trading, namely selling only those loans for which the fair value exceeds the carrying amount, was possible (Wyatt, 1991). In response to these unprecedented financial crises, the SEC advocated a fundamental shift towards fair value accounting (FVA).⁸ R. C. Breeden, the chairman of the SEC at that time, proposed a

⁸ However, the partial suspension of fair value measurement for financial instruments and the swing-back towards historical cost measurement caused by the recent global financial crisis revealed the defectiveness of fair value measurement (Biondi, 2007; Boyer, 2007; Bignon et al.,

comprehensive fair value model for the financial instruments of financial institutions:

It is inherently difficult to distinguish portfolio categories based on intent and ability,... [S]erious consideration must be given to reporting all investment securities at market value.... I believe that it is time to recognize a presumption that market-based information is the most relevant financial data.... The Commission recognizes that the move to a full-scale application of market-based accounting requires careful and deliberate planning (Breedon, 1990, pp.8-9).

After Breedon's statement, the financial instruments project of the FASB was immediately implemented (FASB, 1990, 1991, 1993a, 1993b, 1998).

Fifth, FVA was adopted by *SFAS 121: Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of* (FASB, 1995, superseded by *SFAS 144*). By its nature, HCA did not inquire, except for certain financial instruments, whether future cash inflow generated indirectly by an asset group or a cash-flow-generating unit could collect both book value and expected profit margin in the future. However, by adopting an impairment procedure, the book value of fixed assets came to be understood from the viewpoint of future cash inflow. This viewpoint fits with the economic definition of assets, which refers to the future monetary *entries*. The IASB states that fair value of an asset embodies market expectations for the future recovery of the fair value plus the rate of return available in the marketplace for assets of equivalent risk (IASB, 2005). Given this reasoning, whenever it becomes impossible to expect an asset group to generate minimum market rate of return, *economic* loss must be recognized immediately in the income statement.

Briefly, as shown in Figure 4, HCA evolved by adapting to new environments from a *pure* form of HCA to various *modified* forms of HCA.⁹ Importantly, the SEC advocated a fundamental shift towards FVA to deal with the crisis of savings and loan mutual banks in the 1980s. However, the partial suspension of fair value measurement for financial instruments caused by the recent global financial crisis revealed that fair value is not unconditionally *fair* (Biondi, 2007; Saito, 2009) and results in a high economic risk society through the creation

2009; Saito, 2009).

⁹ From the viewpoint of the pure logic of accounting, which focuses on the economic and monetary process generated by the whole enterprise as an economic entity and a going concern, partial adoption of fair value measurement for financial instruments and adoption of impairment accounting for long-lived assets are no longer considered as a modified HCA, but as a modified FVA (Biondi, 2011).

of financial volatility, the generation of short-termism, and the reinforcement of procyclicality (Boyer, 2007; Bignon et al., 2009).

In Japan, HCA has evolved in very much the same way as in the USA. The lower of cost or market method for inventories was admitted as an exception because the method was generally adopted by accounting practices (BAC, 1962). During the process of global convergence of financial reporting, *Accounting Standard for Measurements of Inventories* (ASBJ, 2006b) was newly established and the lower of cost or market method was applied as the principle. Similarly, the lower of cost or market method for marketable securities was allowed as an exception for the same reason as for inventories (ICBAS, 1949). In addition, *Statement of Position, Accounting Standard for Future, Option, and Other Transactions* (BAC, 1990) was issued in 1990. By this statement of position (BAC, 1990), market values for certain securities and derivatives such as future and option transactions were required to be disclosed as supplementary information.

Regarding inflation-related supplementary disclosure, *Statement of Position, Disclosure of Inflation-related Financial Information in Business Disclosure Systems* (BAC, 1980) was issued. In this statement of position (BAC, 1980), market value disclosure for certain items on the balance sheet and income statement were recommended. However, compulsory disclosure was not required because social consensus on inflation-related information had not been obtained in Japan. Instead, during the Accounting Big Bang period, *Accounting Standard for Financial Instruments* (BAC, 1999) was issued. By this standard (BAC, 1999), held-for-trading securities were measured at market value, and the variance of such items was recognized on the income statement. Similarly, available-for-sales securities were measured at market value, and the variance of such items was displayed in the net asset section on the balance sheet (BAC, 1999; ASBJ, 2008c). In addition, *Accounting Standard for Impairment* (BAC, 2002) was issued, and the impairment procedure for long-lived assets was applied mandatorily.

Together with the development of financial economy and financial technology that focus not on past business transactions, but on current market mechanism, the shift from the revenue and expense view to the asset and liability view as well as the shift from the mixed-attribute measurement model to the single-attribute measurement model have been promoted. Indeed, a comprehensive fair value model for financial instruments was proposed in the late 1990s (IASB, 1997; JWG, 2000). However, the move towards FVA and/or PVA was set in 2008 by the global financial crisis that stemmed from the subprime loan problem. It is important to note that, historically, *modified* HCA was deemed to be a more *sound* accounting practice than FVA and/or PVA.

3.4 Politics of Standards Setting: IASB and FASB Rhetoric

Three characteristics, namely the decision-usefulness approach, the asset and liability view, and the economic definition of assets and liabilities, have provided the momentum to build contemporary accounting (Bromwich, 2004; Tsunogaya, 2009). Similarly, implicit assumptions that support fair value and rhetoric such as fair, standards, high quality, transparent, and comparable used frequently by the IASB and FASB have promoted more than one hundred twenty countries to adopt or permit IFRS. To provide political insight into recent debates on the global convergence of financial reporting, the following paragraphs provide outlines on the features of contemporary accounting and rhetoric of the IASB and the FASB.

First, in contemporary accounting, the decision-usefulness approach is applied as the financial reporting objective. For example, FASB (1978) states that financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of future net cash inflows. This financial reporting objective is future-oriented and originates in the decision-usefulness approach developed by AAA (1966). Second, earnings are defined on the basis of the asset and liability view. For example, FASB (1976) describes that, since assets and liabilities represent the economic resources of an entity and its obligations to transfer economic resources to others, earnings for a period represent an increase in net economic resources of an entity during a period. As such, earnings are precisely defined by definitions of assets and liabilities without relying on the definitions of revenues and expenses.

Finally, economic definitions of assets and liabilities are adopted. For example, FASB (1985) explains that assets are probable future economic benefits obtained or controlled by an entity as a result of past transactions or events. Liabilities are probable future sacrifices of economic benefits arising from present obligations of an entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. Thus, assets and liabilities are defined as future economic benefits and sacrifices that are consistent with the economic definition of assets and liabilities advocated by Economic Monism.

These characteristics have contributed to building contemporary economic-based accounting and direct the global convergence of financial reporting towards FVA and/or PVA model. In addition to this momentum, the IASB has used implicit assumptions and political rhetoric. This proves that accounting standards-setting process is not objective, neutral, and value-free (Zeff, 2002, 2007b). Actually, it is assumed that fair value is relevant to decision-making and reliable in preventing manipulation. The appeal of fair value measurement and economic-based income to standard-setters is in its presumed ability to improve relevancy of decision-making for investors and creditors, while protecting the reliability of financial reporting by minimizing the freedom for managerial

manipulation (Bromwich, 2007). After the late 1990s in particular, the IASB and the FASB proposed fair value measurement actively based on the belief that fair value provides the most relevant information. They proposed the comprehensive fair value measurements model for almost all financial instruments (IASB, 1997; JWG, 2000).

The word *fair* was a clever choice, made in order to win a policy game. Indeed, *fair* is not a measurement rule, but a personal judgment. Sunder argued, “Affixing a new, loaded label to a well-researched and well-discussed method of valuation may amount to playing the old game of policy rhetoric: using clever labels to put the opponents of a proposal on the defensive before the debate even starts. Who would want to defend the use of ‘unfair’ values in accounting?” (Sunder, 2008, p.112) In addition to the word *fair*, political rhetoric pervades many expressions of the IASB, whose success may have been helped by the rhetorical terms that imply positive epistemic virtue, such as “standards,” “high quality,” “transparent,” and “comparable,” without actually referring to empirical impacts on public welfare and investor protection (Biondi & Suzuki, 2007).

As mentioned above, the move towards the adoption of IFRS is driven not only by characteristics of contemporary economic-based accounting such as the decision-usefulness approach, the asset and liability view, and the economic definition of assets and liabilities, but also by the politics of standards-setting bodies by using implicit assumptions, rhetoric, and arguments that manipulate words and phrases.

3.5 Economic Constraints: Recent Financial Crisis

The SEC’s original strategy was to develop accounting standards that could also be recognized by other accounting standard-setting bodies, including IASB (Sugimoto, 2005). However, the SEC changed its strategy to the convergence approach, which sought a single set of high quality financial statements with the IASB (SEC, 2000). In addition, the following three events were influential in forming the move towards the global convergence of financial reporting, namely: (a) the “Sarbanes–Oxley Act,” enacted in 2002 after the Enron and WorldCom scandals; (b) the “Study Report” (SEC, 2003), issued in response to these scandals; and (c) the “Norwalk Agreement,” concluded between the IASB and the FASB in 2002.

These events accelerated the move towards global convergence of financial reporting and promoted the development of objectives-oriented accounting standards and refined conceptual frameworks, and application of the asset and liability view and the single-attribute measurement model (SEC, 2003; Tsumori, 2008). However, the “Emergency Economic Stabilization Act” was enacted in 2008 in reaction to the financial crisis triggered by the Lehman bankruptcy. Section

132 of the Emergency Economic Stabilization Act states that the SEC shall have the authority to suspend the application of *SFAS 157: Fair Value Measurements* (FASB, 2006). Section 133 asserts that the SEC shall conduct a study on fair value accounting to confirm whether or not *SFAS 157* (FASB, 2006) is applicable to financial institutions, including depository institutions.

In particular, the FASB released a staff position, *SFAS 157-3: Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FASB, 2008). This statement confirms that, in determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and discount rates is acceptable when relevant observable inputs are not available (FASB, 2008). As such, even when observable inputs (Level 2) exist, if significant adjustment based on managements' estimation is needed, then a Level 3 fair value measurement would be considered as an alternative. In this Level 3 measurement, unobservable inputs such as present value techniques and option-pricing models are applied. Similarly, the IASB revised *IAS 39: Financial Instruments, Recognition and Measurement* (IASB, 2008a) amid the recent financial crisis. This statement allows an entity to reclassify into the "held-to-maturity" category, in which an amortized cost method is applied, from the "held-for-trading" or "available-for-sale" categories, in which fair value measurement is applied (IASB, 2008a).

In Japan, the ASBJ released *Practical Issue Task Force 26: Practical Solution on Reclassification of Debt Securities* (ASBJ, 2008b) in response to the recent financial crisis. This statement allowed an entity to reclassify into the "available-for-sales securities" category out of the "held-for-trading securities" category for avoiding the recognition of losses on the income statement. This statement also allowed reclassifying into the "held-to-maturity" category out of "held-for-trading" and "other securities" categories for avoiding fair value measurement. As such, this statement has the same effect as *SFAS 157-3* and revised *IAS 39*. Importantly, a board member of the ASBJ opposed this urgent correspondence and countered that accounting standards should be revised on a mid- and long-term basis, not as an urgent correspondence. If accounting standards are changed frequently according to the economic conditions such as boom-and-bust cycles, the trust of accounting standards-setting bodies will be spoiled remarkably (ASBJ, 2008a).

After Breeden's (1990) proposal, the IASB and the FASB expanded the application of fair value measurement. However, even considering financial instruments, the partial suspension of fair value accounting, which was caused by the global financial crisis, proved that comprehensive fair value accounting cannot be applied as an accounting standard for financial instruments. The illusion is that fair value is unconditionally *fair* and transparent, and therefore fair value is the only one measurement basis that provides useful accounting information. This idea is

connected to the world hegemony (Saito, 2009). In the wake of the recent financial crisis, a strong impetus towards FVA was compelled to reconsider the importance of historical cost measurement.

4. Japanized Process of Convergence

4.1 Three Genealogies and Two Accounting Roles

As shown in Figure 3, the holistic theoretical contextual framework does not deny the traditional framework. Instead, it includes measurement and recognition issues in its theoretical structures. Table 1 summarizes the characteristics of Accounting Monism, Economic Monism, and Economic and Accounting Dualism and their confrontational accounting roles. The following sections explain Japan's position against the IASB's recent proposals by referring to contextual factors such as legal, historical, political, and economic environments.

Table 1 - Three Genealogies and Two Accounting Roles

	Accounting Monism	Economic and Accounting Dualism	Economic Monism
Income concepts (realization)	Past-oriented (realization is defended stoutly)	Past-and Future-oriented (realization is important)	Future-oriented (realization is unnecessary)
Definition of assets	Actual monetary exit (emphasis on cash outflow)	Acquired cost/Deprival value (emphasis on cash outflow)	Future economic benefits (emphasis on cash inflow)
Measurement bases	Single measurement basis by historical cost	Multiple measurement bases by historical cost, replacement cost, and fair (present) value	Single measurement basis by fair (present) value
Self-generating goodwill	Unrecognized on the balance sheet	Goodwill bridges the gap between economic income and accounting (or tangible) income	Recognized on the balance sheet
Accounting Roles	Calculation of distributable and taxable income (reconciliation role)		Provision of decision-useful information (information providing role)

In 2005, the IASB issued *Discussion Paper: Measurement Bases for Financial Accounting — Measurement on Initial Recognition* (IASB, 2005). In the discussion paper, the decision-usefulness approach, future economic benefits, and fair value measurement are closely connected to one another. This discussion paper deems fair value to be an ideal measurement basis and treats other values such as

deprival value, replacement cost, net realizable value, and historical cost as surrogates of fair value. We can regard the discussion paper to be based on Economic Monism. In recent years, discussions on “inner compatibility” of accounting concepts have become rare. If provision of decision-useful information is considered to be the only role of financial reporting, the inner compatibility of accounting concepts is not necessarily demanded. The only objective in this case is to select a combination of accounting procedures in accordance with the preference of financial reporting users.

However, this situation would cause confusion because inconsistencies among accounting standards would become apparent. For example, depreciation procedures are applied to tangible fixed assets, whereas impairment procedures are applied to intangible fixed assets including purchased goodwill. Moreover, we become accustomed to an illogical argument that tries to pack *exit* value, such as net realizable value and net selling price, and *entry* value, such as replacement cost and current cost, into a large measurement vessel of “fair value.” If we prepare financial statements according to the preference of users, we cannot provide reliable information and achieve reconciliation of interests among stakeholders, which requires *objective* and *verifiable* accounting figures.

4.2 *Historical Cost Accounting versus Fair Value Accounting: Boundary α*

As shown in Figure 5, this paper positions FVA between HCA and PVA, and investigates the meanings of “Boundary α ” (boundary between HCA and FVA) and “Boundary β ” (boundary between FVA and PVA). These boundaries are unclear in providing necessary information for investors because financial statements can easily shift among HCA, FVA, and PVA according to investors’ information needs. However, these are important boundaries for reconciling interests among stakeholders because the reconciliation manners of interests including distribution of resources can change considerably according to these boundaries.

It is important to note that fair value is a multi-sense term that includes not only quoted prices and observable inputs (level 1, 2), but also unobservable inputs by using present value techniques and option-pricing models (level 3). Although the present positions of the IASB, the FASB, and the ASBJ are between Boundary α and Boundary β , the destination of global convergence of financial reporting would depend on the type of FVA. This measurement issue directly relates to complex and controversial issues such as performance reporting and comprehensive income.

According to *SFAS 130: Reporting Comprehensive Income* (FASB, 1997), comprehensive income is calculable by adding unrealized holding gains to net income as follows, “Comprehensive income equals Net income (realized income)

plus Other comprehensive income (unrealized income) minus Recycling amount.” Importantly, net income is calculated as the difference of realized revenues and matched expenses, whereas other comprehensive income is calculated as changes in values. As such, in order to calculate net income and avoid double counting other comprehensive income, amounts recognized in net income in the current period that were recognized in other comprehensive income in the current or previous periods should be adjusted through the recycling process (Johnson & Lennard, 1998; Tsujiyama, 2009). On the other hand, according to *SFAC 6: Elements of Financial Statements* (FASB, 1985), comprehensive income is defined as the change in the equity of an entity during a period of transactions as well as other events and circumstances from non-owner sources.

Figure 5 - Two Major Boundaries

Notes: A: Assets L: Liabilities E: Equity

HCA: Historical Cost Accounting FVA: Fair Value Accounting PVA: Present Value Accounting

Boundary α and β are mutually related. For example, goodwill becomes smaller as the range of revaluation becomes large.

The calculation systems of comprehensive income defined in *SFAC 6* (hereinafter called “*Calculation A*”) and *SFAS 130* (hereinafter called “*Calculation B*”) differ significantly. Each comprehensive income is calculated using different types of calculation systems as shown in Figure 6. According to *Calculation A*, income is calculated by changes in net assets at the beginning and end of the accounting period, excluding changes in capital transactions. Under *Calculation B*, net income is first calculated by comparing realized revenues and matched expenses during the accounting period. Then the amount of changes in certain items such as unrealized gains on available-for-sales securities and foreign currency translation adjustments are added. Moreover, in *Calculation A*, if all assets and liabilities are valued on the basis of fair value, all holding gains and losses must be reported, whereas in *Calculation B* other comprehensive income need not include all gains and losses.

Figure 6 - Two Types of Comprehensive Income Calculations

Under *Calculation A*, income is decided by the definitions and measurement bases of assets and liabilities. However, under *Calculation B*, income decides the definitions and measurement bases of assets and liabilities. In other words, under *Calculation B* it is important to distinguish realized income and unrealized income, which implies that not all holding gains are included in other comprehensive income. Indeed, under *SFAS 130*, other comprehensive income includes only a portion of holding gains or losses, such as unrealized gains on available-for-sales securities and foreign currency translation adjustments.

Accounting Monism calculates net (realized) income, whereas Economic Monism calculates comprehensive income. Although both relate to a “single-perspective,” the former calculates net income for the stewardship, dividends, and taxes measures, whereas the latter focuses on comprehensive income as shareholders’ performance measure. In other words, net income represents a firm’s *actual* activity and therefore captures the firm’s dynamic aspect as it stands. On the other hand, comprehensive income represents the *result* of investments at a closing date and therefore captures the market’s static aspect (Paton & Littleton, 1940; Littleton, 1953; Edwards & Bell, 1961; Boulding, 1977; Black, 1980). In addition, in the HCA system, income shows a measure of the firm’s performance as a wealth creator because income is generated by the firm’s activities as a whole. In contrast, in the FVA system, the evaluation based on income gives too much weight to short-term market prices because income is modified by capital gains and potential losses (Bignon et al., 2009). As such, the revision of accounting principles and standards changes performance measures, thereby modifying management incentive and evaluation systems.

On the contrary, Economic and Accounting Dualism maintains both accounting and economic perspectives. This “dual-perspective” includes both net income and comprehensive income based on recycling as performance measures. Net income is calculated as the difference of realized revenues and matched expenses, whereas comprehensive income is calculated as changes in net assets. As such, in order to calculate net income and avoid double counting comprehensive income, amounts recognized in net income in the current period that had been recognized in comprehensive income in the current or previous periods should be adjusted through the recycling process. As shown in Figure 7-1, there is no doubt that the performance report proposed by *SFAS 130* relates to Economic and

Accounting Dualism. However, the matrix format of performance reporting proposed by the IASB (2002), shown in Figure 7-2, which separates the entity's activities into business and financing activities, is more complex.

At first glance, the matrix format seems to relate to Economic and Accounting Dualism because two major components, namely the business and financing categories, are distinguished. However, the matrix format is also related to Economic Monism because it does not aim at distinguishing realized income and unrealized income. If the amounts recognized in (other) comprehensive income are transferred to net income when the items are realized, comprehensive income and realized income are distinguishable even under the matrix format. Indeed, a joint discussion paper entitled *Preliminary Views on Financial Statement Presentation* (IASB, 2008b) compromised with the critical opinions against eliminating net income and therefore adopted this type of complex reporting format.

Revenues	X X
Expenses	X X
.....	<u>X X</u>
Net Income	X X
Other comprehensive Income	<u>X X</u>
Comprehensive Income	<u>X X</u>

Figure 7-1 - FASB's One-Statement Approach

	Total	Income before remeasurements	Remeasurements
Business	X X	X X	X X
Financing	X X	X X	X X
Tax	<u>X X</u>		
Comprehensive Income	<u>X X</u>		

Figure 7-2 - IASB's Matrix Approach

The Nippon Keidanren (the Japan Business Federation), which is the biggest business federation in Japan, has opposed the discarding of the concept of net income and the prohibition of recycling. Net income is recognized by the realization principle, whereas comprehensive income is recognized by changes in net assets. In order to calculate net income and avoid double counting comprehensive income, the recycling procedure is indispensable. The Nippon Keidanren opposed the IASB's proposals because it was inconceivable that

comprehensive income could be chosen by the IASB after full deliberation was carried out based on logical and empirical examination (Nippon Keidanren, 2003).¹⁰ The Study Group on the Internationalization of Business Accounting adopted the same position and states that net income is based on the concept of realization. Thus, it facilitates the forecasts of future profits and cash flows. Accordingly, it is essential from the perspective of financial statements usefulness to permit recycling and the concurrent presentation of net income as it is practiced today, even if the disclosure of comprehensive income is adopted (METI, 2004).

Briefly, the IASB (2008b) made a more realistic proposal that allowed the disclosure of net income based on recycling from other comprehensive income to net income. However, the philosophy of the IASB has remained unchanged since the project started in 2001. A critical loophole concerns the concept that recycling from other comprehensive income to net income should be decided by each individual standard without establishing a general rule. Accounting standards such as *IFRS 9, Financial Instruments* (IASB, 2009), which do not necessarily require recycling, are newly established. In addition, the IASB released *Exposure Draft: Presentation of Items of Other Comprehensive Income, Proposed Amendments to IAS 1* (IASB, 2010) in which recycling to calculate net income is not necessarily required. Even if net income is recalculated through the recycling process, the information value of IFRS does not decrease. However, the IASB has not adopted an amenable attitude toward recycling.

4.3 Fair Value Accounting versus Present Value Accounting: Boundary β

The difference between FVA and PVA relates to intangibles or self-generating goodwill, which is defined as the difference between the fair value and the value of the firm. Importantly, boundary α and β are mutually related because unrecognized intangibles become smaller as the scope of fair value measurements increase. Some assume that intangibles should be recognized on the balance sheet, whereas others insist that sufficient intangibles-related information should be provided in a more standardized manner (Blair & Wallman, 2001; Lev, 2001). Intangibles have material economic value and fit with the so-called “New Economy,” in which economic growth is driven by intangibles with innovative and technological progress. In fact, there is no basis from the investors’ point of view for treating investments in intangible capital differently from investments in plant and equipment, or tangible capital (Corrado et al., 2005).

¹⁰ Nippon Keidanren (2003) claimed that, if recycling adjustment is prohibited under the concept of comprehensive income, financial reporting users cannot estimate net (realized) income nor consider income as the accomplished part of historical cost invested by the firm.

Indeed, impairment procedures for goodwill described in *SFAS 142: Goodwill and Other Intangible Assets* (FASB, 2001) and the full goodwill method defined in *SFAS 141: Business Combinations* (FASB, 2007) result in self-generating goodwill being partially recognized on the balance sheet. *SFAS 142* does not require companies to recognize amortization costs on a regular basis or impairment losses as long as the value of the firm or cash-flow-generating ability has been maintained.¹¹ In addition, *SFAS 141* requires companies to recognize assumed goodwill even though they have not purchased the goodwill belonging to non-controlling interests, which implies the minority interests in consolidated subsidiaries.

Consider an extreme case in which financial statements reflect all future cash flows. The cleverer we estimate present value of future cash flows, the closer the amount of net assets approximate to the market value of the company. In an extreme case, no additional information with regard to the income statement is needed. All one needs is the balance sheet and a note of the number of shares in issue (Lennard, 2002). However, even if intangibles become an increasingly important impetus for the new economy, it is not necessarily implied that all intangibles should be recognized on the balance sheet. It is important to note that the estimation of economic value, namely present value of future cash flow that includes intangibles, is the function of the market, not accounting. Sorter argues, “Information provided by the accounting process should be unambiguously characterized and communicated as an input to evaluation models; it should give no pretense of being the ultimate output or result of evaluation models” (Sorter, 1974, p.107). Similarly, accounting information should confirm whether investor’s speculation about the economic value is justified, but should not engage in the speculation (Penman, 2003).

Recognition of intangibles on the balance sheet causes other problems. Some researchers discuss simultaneously accounting for research and development (R&D) costs and accounting for self-generating goodwill (Blair & Wallman, 2001; Eccles, et al., 2001; Lev, 2001). However, these two accounting procedures are considerably different from each other. Accounting for R&D and other costs such as education and training, advertisement and promotion costs relate to allocations of past cash outflow (see Figure 8: B/S view I), whereas accounting for self-generating goodwill relates to the ability to generate future cash inflow (see Figure 8: B/S view II).

Similarly, the accounting definition of assets implies the actual monetary *exit*, whereas the economic definition of assets implies the future monetary *entries*

¹¹ This is a case for the political process having a significant influence on the accounting standards-setting process. By lobbying against the FASB’s proposal, which eliminates the pooling method, opponents achieved a compromise that eliminated amortization of goodwill and replaced it with impairment (For details, see Watt, 2006).

(Biondi, 2007). Thus, according to the accounting definition, a portion of the R&D costs, namely payments not yet recognized as expenses, can be recognized on the balance sheet (Paton & Littleton, 1940; Schmalenbach, 1980; Biondi & Rebérioux, 2008). On the other hand, self-generating goodwill can be recognized only when the economic definition is applied. The former fits with Accounting Monism, whereas the latter corresponds to Economic Monism.

Importantly, we cannot draw a clear line between asset revaluation movements in the USA in the 1920s and 1930s and recent arguments to recognize self-generating goodwill. These are upward asset revaluation practices without any *actual* transactions, separability, and marketability, and therefore permit room for accounting fraud and the acceleration of economic crises.

Figure 8 - Different Balance Sheet Views

Notes: Only fixed asset and liability are considered. Current asset and liability are omitted.

COF: Cash Out-Flow, CIF: Cash In-Flow

Even under B/S view I, asset is measured on the basis of CIF in a subsequent measurement for cases such as the lower of cost or market method and impairment accounting.

In Japan, capital section on the balance sheet is called “Net Asset Section” (ASBJ, 2005).

4.4 Theoretical Foundations of Japanese Accounting Regulations

As discussed earlier, in developed countries accounting systems are distinguishable into two groups. One is the Anglo-American model used in countries such as the UK, the USA, Australia, and Canada. The other is the Continental-European model used in countries such as Germany, France, and Japan (Nobes, 1992; Dougnik & Perera, 2009). Because of global convergence of financial reporting, almost all countries have adopted the Anglo-American model. The Japanese government, Japanese standards-setting bodies such as the BAC and the ASBJ, business federations such as Nippon Keidanren, and academics have largely been pushed

towards the “Americanization of Convergence,” which has developed over a long period of time in a particular socio-economic and political environment. However, *excessive* Americanization has been opposed by Japanese stakeholders in some cases. To gain insights into the *Japanized* process of convergence, the following paragraphs provide details on Japanese accounting regulations and recent reforms of accounting and related systems.

The first Japanese accounting principles entitled *A Statement of Business Accounting Principles (Kigyo Kaikei Gensoku)* (hereafter abbreviated to the *Business Accounting Principles*)¹² were established after World War II, and they still play a role in the Japanese accounting system. The *Business Accounting Principles* are based on the revenue and expense view, historical cost basis, and realization principle. According to the *Business Accounting Principles*, assets must be measured on the basis of historical cost, and revenues must be measured on the basis of receipts when cash or cash equivalents are realized (ICBAS, 1949). Thus, assets are not measured on the basis of future cash inflow, but on past cash outflow in an initial measurement (Figure 8, B/S view I). The characteristics of the *Business Accounting Principles* are stated in the foreword as follows:

The principles should be abided by all enterprises in doing accounting procedures, even though the principles are not forced to do so by laws or ordinances.... The principles should be respected in cases that related laws and ordinances, such as the Commercial Code, the Corporation Tax Law, and the Price Control Ordinance, are established, amended or abolished in the future (ICBAS, 1949, foreword).

As such, the *Business Accounting Principles* was considered as the Accounting Constitution with which all related laws and ordinances had to abide. However, the Accounting Big Bang commenced in 1997 as part of the Financial Big Bang. The goal was to establish free, fair, and global financial markets by accelerating large-scale deregulation and liberalization (Economic Council, 1996). During the Big Bang, fair value measurements were adopted partially to accounting for financial instruments, impairments, mergers and acquisitions (M&A), and pensions, not only in accounting standards, but also in the Commercial Code and the Corporation Tax Law. Consequently, contemporary accounting standards, especially those established after the mid-1990s, measure assets on the basis of future cash inflow (Figure 8, B/S view II).

¹² *Business Accounting Principles* were prepared by the Investigation Committee on Business Accounting Systems (ICBAS) within the Economic Stabilization Board. The Board changed its name to the Business Accounting (Deliberation) Council (BAC) in 1952.

Thus, the *Business Accounting Principles* was compelled to change its status from the Accounting Constitution, which did not allow individual accounting standards to describe different accounting treatments, to a General Statute that can be suspended by newly established individual accounting standards (Ando, 2010). However, even after significant reforms of accounting standards and the EC's announcement that Japanese GAAP is equivalent to IFRS adopted by the EU (EC, 2008), which implies the move towards the Anglo-American model, the theoretical foundations of Japanese accounting regulations are maintained.

In particular, net income is still important, not only for the provision of decision-useful information, but also for the reconciliation of interested parties (ASBJ, 2006a; METI, 2004; Nippon Keidanren, 2003; Saito, 2010b). Because net income provides relevant and reliable information, net income is equated with comprehensive income in *Discussion Paper: Conceptual Frameworks of Financial Accounting* (ASBJ, 2006a). Moreover, if a company distributes unrealized income, it cannot maintain security for creditors, and reconciliation of interests can no longer be accomplished. The Companies Act prescribes the maximum amount of surplus available for distribution on the basis of accumulated realized income to avoid excess outflow of assets from a company. Net income is also used as a basis for the calculation of taxable income under the Corporation Tax Law.

It should also be noted that, after the Accounting Big Bang, the triangular legal system changed from a strong equilibrium to a weak equilibrium. In 1997, consolidated financial statements became the main financial reporting under the Securities and Exchange Law (currently the Financial Instruments and Exchange Act), while nonconsolidated financial statements are the main subject of the Commercial Code (currently the Companies Act). Therefore, the separation of these statements is progressing gradually. Moreover, since tax effect accounting was introduced in 1998, the separation of accounting standards and the corporate tax law is also progressing gradually. These changes of the triangular legal system were made so that Japanese standards-setting bodies could revise accounting standards quickly according to the revision of IFRS.

To promote accounting reforms further, a new accounting standards-setting body was established. In July 2001, the ASBJ and the Financial Accounting Standards Foundation (FASF), which is the oversight body of the ASBJ, were established as private sector organizations to replace the BAC, which is a public sector council under the strong control of the Congress and the government. The objective of the ASBJ and the FASF is to promote corporate disclosures and the soundness of capital markets in Japan by developing generally accepted accounting standards. The establishment of the ASBJ as a private accounting standards-setting body is significant because it enables a dramatic change towards global convergence of financial reporting beyond the restrictions of the Companies Act and the Corporation Tax Law (Egashira, 2005; Saito, 2007).

4.5 Implications from the Holistic Theoretical Contextual Framework

As discussed in Sections 4.2 to 4.4, the Japanese government, Japanese standards-setting bodies such as the BAC and the ASBJ, business federations such as Nippon Keidanren, and academics have largely been pushed towards “Americanization of Convergence.” However, they have opposed *excessive* Americanization in some cases. To gain insights into the *Japanized* process of convergence, this paper developed a holistic theoretical contextual framework that includes historical, political, and economic factors. This framework provides the following useful implications.

Because Japan has globalized large-scale capital markets and a well-organized accounting system, it would be futile to adopt IFRS unquestioningly without reforming related infrastructures such as financial systems, related laws, auditing standards, and standards-setting bodies. In Japan, the legal environment is important because three related laws, namely the Financial Instruments and Exchange Act, the Companies Act, and the Corporation Tax Law, connect with each other and form the triangular legal system. This unique legal system has contributed to creating the prudent and conservative nature of the Japanese accounting system. However, the Japanese *cautious approach*, which aims at reducing disparities between the Japanese accounting system and IFRS, differs significantly from conservative measurement models proposed by international accounting research (Gray, 1988; Nobes, 1992; Doupnik & Perera, 2009). Compared to countries such as the EU and Australia, which rushed towards IFRS in 2005, Japan is currently undergoing a prolonged, complex, and controversial process for aligning its entire accounting system with IFRS. Importantly, the accomplishment of the Accounting Big Bang and significant reforms towards convergence of IFRS resulted in high quality accounting standards. As a result, the EC suggested that Japanese GAAP is equivalent to IFRS that was adopted by the EU (EC, 2008).

The historical environment provides further insight into recent debates on global convergence of financial reporting. A brief history of the development of accounting standards in the USA indicates that HCA evolved from a *pure* form of HCA to various *modified* forms of HCA. The modified HCA took into account the lower of cost or market method, market-related supplementary disclosure, partial adoption of fair value measurement for financial instruments, and adoption of impairment accounting for long-lived assets. In Japan, HCA has evolved in very much the same way as in the USA. This finding provides useful insights into the application of Economic and Accounting Dualism. The reconciliation of heterogeneous concepts such as future and past measurement attributes, asset-and-liability view and revenue-and-expense view, as well as information

providing role and reconciliation role can be achieved in various ways. In particular, the adjustment can be made not only by replacing historical cost with fair value or present value at the *recognition* level, but also by supplementary disclosure of monetary (quantitative) and narrative (qualitative) information at the *disclosure* level.

Contrary to accounting practices based on Economic and Accounting Dualism, implicit assumptions, politics, and rhetoric from the IASB and the FASB have contributed to the move towards Economic Monism. Specifically, the IASB and the FASB use an implicit assumption that fair value provides the most relevant information for investors. Furthermore, these boards seek an *ideal (but unreal)* set of high quality financial statements with political rhetoric such as fair, high quality, transparency, and comparability. In addition, the linkage among the asset and liability view, fair value measurement, and comprehensive income has been encouraged in recent debates on global convergence of financial reporting.

Japanese standards-setting bodies, ministries, business federations, and academics have opposed some *excessive* cases (ASBJ, 2006a; METI, 2004; Nippon Keidanren, 2003; Saito, 2010b). Among other points, Japan has opposed the discarding of the concept of net income and the prohibition of recycling from comprehensive income to net income. The reasons for this are not only to maintain Japanese-specific features such as the triangular legal system, calculation of surplus available for distribution and taxable income, but also to provide relevant information for investors' decision-making. Even if the matrix format of performance reporting (Figure 7-2) is applied by the IASB, as long as amounts recognized in comprehensive income are recycled to net income at the time of realization, comprehensive income and realized income are distinguishable. Discarding of the concept of net income and the prohibition of recycling from comprehensive income to net income is largely based on the IASB's *biased* belief.

This IASB's biased belief ignores contextual factors such as the legal, historical, political and economical environments of Japan. This belief also disregards the fact that the Japanese accounting system has evolved with related infrastructures such as financial systems, governance structures, related laws, auditing standards, and standards-setting bodies. In addition, based on the belief that fair value provides the most relevant information, the IASB and the FASB have proposed fair value measurement exclusively. Indeed, they proposed the comprehensive fair value measurements model for almost all financial instruments (IASC, 1997; JWG, 2000). However, the partial suspension of fair value measurement (IASB, 2008a; FASB, 2008; ASBJ, 2008a, 2008b) caused by the recent global financial crisis proved that the comprehensive fair value measurement model is not appropriate, even for financial instruments. This economic crisis has revealed that fair value is *fair* only when an efficient market hypothesis is assumed (Biondi, 2007). Bignon et al. (2009) criticize FVA further to the effect that an

evaluation based on fair value income gives too much weight to short-term market prices because fair value income is modified by capital gains and potential losses. As such, FVA changes performance measures, management incentives, and evaluation systems into short-termism.

This excessive emphasis on Economic Monism and extensive application of fair value measurement causes other problems. FVA involves the unstable nature of markets and managements' estimation, while FVA excludes the stable nature of Japanese traditional concepts such as revenue and expense view, historical cost basis, and realization principle. Although the SEC has developed a vector for FVA since the 1990s (Breedon, 1990), the SEC is convinced that fair value measurement, especially level 3, which uses reporting entity's assumptions about future cash flows and discount rates, is not necessarily useful for preventing accounting fraud. Indeed, Enron abused FVA to protect managers' compensation by increasing current period earnings and stock values (Benston, 2006). Moreover, fair value causes significant problems such as the creation of financial volatility and fragility, the generation of short-termism, the lack of the ability to mediate imminent conflicts arising from the diversity of stakeholders, and the reinforcement of the accelerator effect called "procyclicality" (Boyer, 2007; Bignon et al., 2009). In contrast, according to the arguments analyzed by Laux and Leuz (2009), proponents of fair value insist that HCA is unlikely to be the remedy for economic crises. Furthermore, procyclicality is not a matter of FVA, but rather a matter of banking regulations. In addition, it is not proved that contagion is positively related to the accounting system.

However, both proponents and opponents of FVA seem to agree that the extensive application of fair value measurement causes implementation problems. Moreover, excessive emphasis on Economic Monism leads to a high economic risk society, which has inevitably led to the recent swing-back. Ijiri (2005, p.274) once warned:

The monistic push for relevance alone will be curtailed and the trend toward adding more and more forecasts to accounting will be reversed as it is too risky.... [The] asset-liability view... may be forced to entertain a move toward the revenue-expense view simply because the latter is much more reliable.... [U]nder the asset-liability view, self-developed goodwill will be something that is desirable to include on the balance sheet to make it more comprehensive, even though its measurement is not reliable.

5. Conclusions

Three heterogeneous genealogies provide some useful insights into issues such as controversial measurement and recognition bases in each country. Specifically,

these genealogies are: Accounting Monism, developed by AAA (1936), Paton and Littleton (1940), and Schmalenbach (1980); Economic Monism, developed by Canning (1929), AAA (1957), and Sprouse and Moonitz (1962); and Economic and Accounting Dualism, developed by Alexander (1950) and Barton (1974). Nevertheless, this framework cannot fully explain the complexity of the unique environment in each country and ignores the importance of social, historical, political, and economic factors on the evolving nature of accounting in the globalized world. As a result, this paper has developed a holistic theoretical contextual framework by referring to the accounting ecology frameworks developed by Gernon and Wallace (1995) and applied by Perera and Baydoun (2007), Baker et al. (2010), Heidhues and Patel (2010), and Hellmann et al. (2010). This framework makes it possible to examine the *Japanized* process of convergence, which aims at integrating the Japanese-specific accounting system with IFRS and the Anglo-American model, thereby achieving *de facto* convergence. This framework considers four contextual dimensions, namely legal, historical, political, and economic environments, in addition to Accounting Monism, Economic Monism, and Economic and Accounting Dualism.

The Japanese government, Japanese standards-setting bodies such as the BAC and the ASBJ, ministries, business federations such as Nippon Keidanren, and academics have largely been pushed towards “Americanization of Convergence.” However, *excessive* Americanization has been opposed in some cases. In particular, Japanese stakeholders have opposed discarding the concept of net income and the prohibition of recycling from comprehensive income to net income (ASBJ, 2006a; METI, 2004; Nippon Keidanren, 2003; Saito, 2010b). Arguments against global convergence of financial reporting arise from basic accounting concepts such as the revenue and expense view, historical cost basis, and realization principles, which are still the foundations of Japanese accounting regulations. Indeed, Japanese standards-setting bodies, ministries, business federations, and academics have maintained heterogeneous concepts such as future and past measurement attributes, asset-and-liability view and revenue-and-expense view, as well as the information providing role and reconciliation role simultaneously (ASBJ, 2006a; METI, 2004; Nippon Keidanren, 2003; Saito, 2010b). As such, the principal concern here is not only to maintain Japanese-specific features such as the triangular legal system, calculation of surplus available for distribution, and taxable income, but also to provide relevant information for investors’ decision-making (ASBJ, 2006a; METI, 2004; Nippon Keidanren, 2003; Saito, 2010b).

Importantly, the triangular legal system is changing from a *strong* equilibrium form in which three laws are strongly tied up to a *weak* equilibrium form in which functional decompositions of these three laws are progressing gradually. Indeed, the Financial Instruments and Exchange Act regulates mainly

consolidated financial statements by which the application of IFRS is planned. On the other hand, the Companies Act regulates mainly non-consolidated financial statements to which Japanese GAAP is applied. Similarly, because of the introduction of tax effect accounting, the separation of financial reporting and the calculation of taxable income is progressing. These functional decompositions were made so that Japanese standards-setting bodies could revise Japanese accounting standards quickly according to the revision of IFRS beyond the restrictions of the Financial Instruments and Exchange Act, the Companies Act, and the Corporation Tax Law (Egashira, 2005; Saito, 2007). These functional decompositions made it possible to promote the *Japanized* process of convergence.

In addition, two major boundaries between HCA and FVA and between FVA and PVA provide useful insights into the *Japanized* process of convergence. The boundary between HCA and FVA argues for the presentation of financial statements. Monism does not aim at reconciling heterogeneous concepts. Accounting Monism provides only historical cost information, and Economic Monism provides only fair value information. In contrast, Economic and Accounting Dualism aims at reconciling heterogeneous concepts such as historical cost and fair value information as well as net income and comprehensive income. This relationship is illustrated as follows: “Net income (realized income) plus Other comprehensive income (unrealized income) minus Recycling amount, is equal to Comprehensive income.” Importantly, net income is calculated as the difference between realized revenues and matched expenses, whereas other comprehensive income is calculated as changes in values. As such, in order to calculate net income and avoid double counting other comprehensive income, amounts recognized in net income in the current period that were recognized in other comprehensive income in the current or previous periods should be adjusted through recycling process (Johnson & Lennard, 1998; Tsujiyama, 2009).

If the matrix format of performance reporting (Figure 7-2), which relies on a dichotomy between operating and financing activities, is applied by the IASB, recycling is indispensable for distinguishing comprehensive income and net income, thereby achieving *de facto* convergence of IFRS in Japan. However, the IASB is not amenable to recycling. Even if this recycling is applied by the IASB, the information value of IFRS does not decrease. Discarding and prohibiting the concepts of net income and recycling are based on the IASB’s *biased* belief. In particular, the IASB has used an implicit assumption that fair value provides the most relevant information for investors. Furthermore, political rhetoric using words and phrases such as fair, high quality, transparency, and comparability supports the extensive application of fair value measurement and the concept of comprehensive income.

The boundary between FVA and PVA provides further insights into the *Japanized* process of convergence, which is related to the recognition of

self-generating goodwill. Economic Monism enables the recognition of self-generating goodwill on the balance sheet because it satisfies the economic definition of assets, which are defined as the ability to provide future service or generate future cash flows (Biondi, 2007). However, self-generation goodwill has not been recognized on the balance sheet for a long time, especially after the lesson of unsound assets revaluation practices in the USA. This indicates that contemporary accounting concepts are still rooted in accounting practices that rely mostly on Economic and Accounting Dualism. It is also important to note that the present IFRS is based on neither *pure* FVA nor *pure* PVA, but on *modified* HCA. Fair value and present value measurement bases are not applied for all assets and liabilities, but multiple measurement bases are applied for these items. Therefore, Economic and Accounting Dualism provides useful insights into the current positions of the IASB, the FASB, and the ASBJ.

Contrary to accounting practices based on Economic and Accounting Dualism, the move towards global convergence of financial reporting has been supported by the objectives-oriented approach, refined conceptual frameworks, the asset and liability view, and the single-attribute measurement model (SEC, 2003; Tsumori, 2008). Indeed, the IASB and the FASB emphasize the information providing role rather than the reconciliation role, the balance sheet rather than the income statement, fair value rather than historical cost, and comprehensive income rather than net income (Benston et al., 2007). By encouraging the linkage among the information providing role, the asset and liability view, fair value measurement, and comprehensive income, this approach would focus on Economic Monism.

Historical evolution provides useful insights into the application of Economic and Accounting Dualism in the rush towards global convergence of financial reporting. In particular, HCA evolved by adapting to new environments from a *pure* form of HCA to various *modified* forms of HCA. The modified HCA involved the lower of cost or market method, inflation-related supplementary disclosure, partial adoption of fair value measurement for financial instruments, and adoption of impairment accounting for long-lived assets. This finding shows that the reconciliation of heterogeneous concepts can be achieved not only by replacing historical cost with fair value and/or present value at the *recognition* level, but also by the supplementary disclosure of monetary (quantitative) and narrative (qualitative) information at the *disclosure* level.

In contrast, excessive emphasis on Economic Monism and extensive application of fair value measurement causes accounting, political and economic problems. The partial suspension of fair value measurement and the swing-back towards historical cost measurement caused by the recent global financial crisis revealed that fair value is not unconditionally *fair* (Biondi, 2007). The partial suspension of fair value accounting also proved that comprehensive fair value accounting cannot be applied as an accounting standard for financial instruments.

Connected to the world hegemony is the illusion that fair value is unconditionally fair and transparent, therefore fair value is the only one measurement basis that provides useful accounting information (Saito, 2009). Bignon et al. (2009) criticize FVA further that the evaluation based on fair value income gives too much weight to short-term market prices because fair value income is modified by capital gains and potential losses. As such, FVA changes performance measures, management incentives, and evaluation systems towards short-termism. This excessive emphasis on Economic Monism and the extensive application of fair value measurement result in a high economic risk society through the creation of financial volatility, the generation of short-termism, and the reinforcement of procyclicality (Boyer, 2007; Bignon et al., 2009).

In conclusion, in examining the case of Japan, this paper developed a holistic theoretical contextual framework for providing valuable insights into factors that differentiate the Japanese accounting system from the Anglo-American model, which was developed in a particular socio-economic and political environment. We suggest that social, historical, political, and economic factors cannot be ignored in this rush towards global convergence of financial reporting. We argue further that accounting research can be enhanced by analytically examining the contextual factors in which the uniqueness of accounting systems are embedded.

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