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ACCOUNTING "REVOLUTIONS" IN JAPAN

Abstract: Japan's rise from a feudalistic economy to a position as a leading industrial power is a result, in part, of two revolutionary changes in its accounting structure. The first change came during the latter part of the nineteenth century as part of the Meiji Government's program of modernization. Various political, economic, and cultural institutions were adopted from the West, among them the double-entry method of bookkeeping; this method gradually replaced very unsatisfactory traditional methods. The second change came after World War II, when the Allied Command set as its objective the destruction of the Zaibatsu-dominated industrial structure and its replacement with a democratic economy, in which industrial capital is accumulated through the participation of investors in a free stock exchange. Such a change demanded a shift in emphasis from stewardship-oriented financial reporting to investor-oriented financial reporting.

Accounting history is the study of the evolutionary process in accounting thought, practices, and institutions. The focal point of such study is the dynamic interaction between accounting and its environment. This consideration of the accounting history of Japan, focuses on two significant events in the modern history of Japan that had revolutionary impacts on its accounting system.

The first of the two events, which took place in the latter half of the 1800s, involved the change from traditional diary-style bookkeeping methods to a modern system of accounting within a double-entry framework. The second revolutionary event, which occurred shortly after World War II, involved a virtually overnight change from Japan's traditional stewardship orientation to the investor orientation of financial reporting common in many parts of the world today. These two events are excellent examples of the fact that accounting cannot be understood in isolation, but that an analysis of accounting must include the economic, political, and diplomatic environments in which it is practiced.

The function of accounting is, obviously, to provide information relevant to the decisions of managers, shareholders, creditors, and other parties interested in the process an enterprise uses to manage the capital of individuals or organizations. These parties cannot make relevant decisions without relevant information. Lack of relevant information on which decisions are based affects the development of the economy, which eventually causes the society to become incoherent. Economic development and accounting development go hand in hand, one stimulating and reinforcing the other. Such interaction was particularly strong with respect to the two revolutionary events discussed here.

Generally speaking, revolutions are discontinuities that have continuities in their undercurrent. Wells [1976] adopts the idea of revolution from Kuhn [1970] and identifies five steps in the process of moving from an old set of ideas to a new set: (1) the recognition of anomalies, (2) a period of insecurity, (3) the development of alternative sets of ideas, (4) the identification of schools of thought, and (5) the domination of the new practices or ideas. Wells elaborates on these points:

> The first step is a precursor to the whole process; it initiates the period of crisis which follows. During that period, scientists become increasingly dissatisfied with the existing theoretical framework, and a search for alternatives begins. Therefore, the second and third steps are mutually interactive. As dissatisfaction grows, the search for alternatives gains impetus; as alternatives are discerned and discussed, the dissatisfaction is heightened. Schools of thought emerge, and one set of ideas gradually gains ascendency over the alternatives [pp. 471-472].

This description may well hold true in describing accounting innovations as they took place in Europe and the U.S., but in the case of modern Japan, changes in accounting thought and practice have not always occurred as evolutionary changes in response to changes in the internal environment. Since the latter half of the nineteenth century, Japan's economy, as well as its accounting methods, has been strongly influenced by powerful external forces, particularly from the U.S. and Europe. In this sense, Japan's two important accounting revolutions may best be characterized as imported innovations.

INTRODUCTION OF DOUBLE-ENTRY BOOKKEEPING

In any society and at any period in time, as wealth is obtained and economic activities are conducted, people need some accounting system to record what one has and how it is used. According to Nishikawa [1956], the earliest recorded mention of merchants' books dates to 1520. Ledgers dating from the early 1600s are among writings preserved today. Ogura [1973] reports that the comprehensive record of accounts kept by the Nakai family in 1745, the so-called "Ledger of Good Fortune," although not explicitly employing a two-sided reckoning of debits and credits, did use a double-entry type of bookkeeping approach. Such an approach developed directly from the practices of merchants in Japan and shows no evidence of having been influenced by Western-style bookkeeping methods. This system existed until the middle of the 1800s, when the U.S. and the economic powers of Europe arrived at Japan's door in their search for raw material sources and markets for their products. At that time, Japan came under sudden and tremendous pressure to enter into trade agreements, and, as a result, found itself scurrying to borrow new industrial technology and economic institutions from the West. Western-style double-entry bookkeeping made its entry along with these other importations. Shimme [1937, p. 291] writes that the first use of the new Western-style bookkeeping was by the newly established Yokosuka Steel Plant at the very end of the Edo period in 1865.

Coming into power in 1868, the Meiji government put its entire energy into setting up political, economic, and social institutions based on U.S. and European models. In the midst of such change, the transition from older bookkeeping methods to the Western-style approach was finally accomplished. Two important publications also helped to stimulate its eventual adoption.

In 1872, the year in which the National Bank Act was passed (with Japan's first stock-owned enterprise, the First National Bank, established the next year), the Ministry of Finance published *Bank Bookkeeping Methods,* which became the first work dealing with double-entry bookkeeping to appear in Japan. This work was a five-volume translation compiled from proposals by Alexander Allen Shand (1844-1930), a Scotsman who came to Japan at the invitation of the Ministry of Finance to teach the Japanese bookkeeping methods for banks. In his introduction to *Bank Bookkeeping Methods* [1873], Yoshikawa, the compiler of this work, describes how this came about:

> From times of old there has existed no fixed method for keeping accounts in our country, each merchant keeping his own records as he saw fit. Because such books were haphazard and followed no established procedures, problems often arose and it was impossi-

> ble to know what items were important and what items were not. The former Minister of Finance, Kaoru Inoue, was constantly concerned over this state of affairs while in office, and afterwards at the time the National Bank was established he said to me, "This is the first bank to be established in our country. No one has any idea what methods to employ. If accounts are kept in such a haphazard fashion, then mistakes will be unavoidable and things will get out of control. I heard about an Englishman by the name of Shand, who is knowledgeable in the operation of banks. If this is true, then the best thing to do is have the Ministry invite him to help us set up our banks." Thereupon I accepted his directive and requested Mr. Shand to draw up a draft regarding bank account books and the formats to be used. Adding our own comments to places that were dealt with too simply and shaving down passages that were excessively overworded, we put them together, added an introduction and succeeded in completing a statement regarding bookkeeping procedures and formats to be employed [pp. 1-2].

The first time such bookkeeping methods were actually put to use was in December 1873 when the First National Bank closed its books for the first time and issued financial statements.

In most instances when established structures are replaced with something new, the new item is met with a certain amount of resistance, and the new process takes time to implement. In the case of double-entry accounting, however, it immediately received wholesale acceptance as part and parcel of the new banking system. It spread rapidly after its introduction.

The second important publication affecting the acceptance of the double-entry system was Fukuzawa's *Methods of Bookkeeping.* Part One appeared as two volumes in 1873. This work was, in fact, a translation of the American bookkeeping textbook by Bryant and Stratton, *Common School Bookkeeping* [1871]. Part One of Fukuzawa's work contained the sections on single-entry methods. Part Two, dealing with double-entry bookkeeping methods, came out in 1874, again in two volumes. The publication of Part One of *Methods of Bookkeeping* predated *Bank Bookkeeping Methods* by six months, and for this reason *Methods of Bookkeeping* is often referred to as the first work in Japan dealing with the double-entry bookkeeping framework. Used as a textbook in elementary and junior high schools, this book played a vital role in the eventual acceptance of double-entry bookkeeping methods in Japan.

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In his preface to *Methods of Bookkeeping* [1873], in which he talks about his reasons for translating the original, Fukuzawa makes the following comment:

> In the bookkeeping methods of merchants I have seen or heard about, everything is in a state of confusion. An inventory of a single merchant's stores might take two months, and still not every item could be accounted for. This stands as proof that existing methods are no good, and yet I have yet to hear of anyone correcting the situation. Not only does this create inconveniences for the merchant himself, but for society as a whole. The present translation is only an introduction to Western bookkeeping methods, and although it will not change present methods and eliminate all inconveniences completely, still, familiarization with the bookkeeping fundamentals presented in Part One, followed by a deeper understanding to be obtained from Part Two, will surely eliminate some of the difficulties in public and private accounting throughout the land, to which this book, insignificant as it is, is better than nothing at all [p. 2].

Bank Bookkeeping Methods and *Methods of Bookkeeping* were destined to remedy the deficiencies inherent in the bookkeeping practices followed in Japan at the time. After their publication, a rather long period of time passed before traditional bookkeeping methods were displaced altogether, but eventually merchants and businessmen gave up the old methods and adopted the Western double-entry approach. Truly, the introduction of double-entry bookkeeping stands as a major milestone in Japan's emergence as a modern capitalist nation.

INTRODUCTION OF INVESTOR-ORIENTED FINANCIAL REPORTING

Stock exchanges were opened in Tokyo and Osaka as early as 1878. In spite of this, however, the disclosure of investor-oriented financial information did not appear as a matter of concern in Japan until the middle of the twentieth century. The reasons underlying this delay are described as follows.

The Japanese Commercial Code was enacted in 1890, and the section dealing with companies went into effect in 1893. Undergoing a first amendment in 1899 and several subsequent revisions, this code remains in effect today. Even in its original form we can discover the primitive shape of those statutes pertaining to business accounting and other accounting matters currently in effect. The Commercial Code introduced into Japan a continental style of financial reporting, whereby an "inventory of assets" was prepared and submitted along with the balance sheet and income statement. The inventory of assets included liabilities as negative assets and itemized all movable and immovable properties, securities, and so on, with their assigned monetary values. The inventory's aim was to represent all assets belonging to the business, including liabilities, in a comprehensive manner. The function of the inventory of assets was not always clear because of its substantial overlap in content with the balance sheet. A commonly held view was that it was a prelude to the preparation of the balance sheet. There was also a view that regarded the inventory of assets as complementing the balance sheet by offering quantitative or interpretive details concerning assets and liabilities. Whatever the case, Japanese accounting thought at that time placed this inventory of assets at the central position among the various financial statements and placed greater emphasis on the balance sheet than on the income statement.

During the 1930s and early 1940s, standardization of the financial statements used to disseminate business financial information was urged. Such standardization was part of a government sponsored program of industrial rationalization aimed first at easing the depression, and later at unifying the military state in preparation for war. The Registered Public Accountant Act was passed in 1927, creating the job title of registered public accountant and signifying an attempt to improve the business accounting system. Nevertheless, the idea of the audit of financial statements performed by an independent, publicly certified professional was not fully developed because Japan's vital industries were the exclusive property of large, family-owned industrial conglomerates known as the Zaibatsu. Hence, ideas such as the stock market being a place for industrial capital accumulation, or the function of accounting being to present financial information to investors, were totally irrelevant in Japan.

Littleton and Zimmerman comment in *Accounting Theory: Continuity and Change* [1962]:

> Accounting actions for several generations gave evidence of a belief in the superior importance of the balance sheet. Interest was centered there because of a belief that this statement was at once a report on management's stewardship and a report on company solvency. American opinion in the last thirty years

> has tended to reverse this earlier emphasis, thus expressing the belief that the facts about company net earnings and the supporting detailed data of revenue and expense are of outstanding significance. Earning reports are considered to provide the key to the proper evaluation of management's effectiveness as well as a reliable clue (persistent earning power) to security values [p. 258].

It would not be inaccurate to say that this evolutionary trend in America noted by Littleton and Zimmerman was all but absent from accounting thought, practices, and institutions in Japan until the mid 1940s. Not until 1945 and the close of the second world war did the second great revolutionary change occur in Japanese accounting. This change was imposed at the direction of the Allied Command, which sought to build a democratic economy on the ruins of the dismembered Zaibatsu. In order to take away the controlling power of the Zaibatsu parent company over its various subsidiaries, all shares owned by the parent company and controlling families were forcibly turned over to the Holding Company Liquidating Committee, which sold the subsidiaries at current value to investors in the public sector. The purpose of dismembering Zaibatsu parent companies and turning over exclusively owned business shares to the public was to destroy, once and for all, the entire Zaibatsu empire, as well as to recruit investors from the public for the purpose of raising industrial capital.

The Securities and Exchange Act patterned after the American system was passed in 1947, was amended the following year, and was put into effect. In 1949 the stock exchange, which had been closed for many years, was reopened. Amendments to the Commercial Code in 1948 and 1950 prohibited the installment payment system for stocks and adopted instead a system of authorized shares that could be issued as the need arose. Likewise, non-par value shares were recognized. The results of such measures greatly affected the organizational and operational aspects of businesses.

Besides institutionalizing the disclosure of financial information directed toward the investor, the Securities and Exchange Act also stipulated that all business financial statements be audited as the primary tool for disseminating financial information. Thus, in one fell swoop, the idea of presenting accurate and useful information regarding current period earning power to the investor came to the foreground in Japanese accounting thought. In 1948 the Registered Public Accountants Act was replaced by the Certified Public Accountants Act. The first CPA examination was given in 1949. Also in that year, the Economic Stabilization Board's Investigation Committee on Business Accounting Systems published as its interim report, "Financial Accounting Standards for Business Enterprises," intended to serve as a standard in the preparation of financial statements. The preface to "Accounting Standards" [ESB, 1949] stated that "[such standards] represent a condensation of practices that are considered to be generally accepted as being fair and proper from among those developed in the practice of business accounting" (para. 2). Its content, however, reflected the newly imposed idea of depicting the earning power of a business by means of income in the current period, as well as the disclosure of such financial information as is useful to the investor in making investment decisions. "Accounting Standards" thus assured that the new accounting revolution would find immediate and universal acceptance.

"Accounting Standards" continues to the present day with slight amendment. At the time of its drafting, Kurosawa, one of the members of the drafting committee, explained its nature as follows:

> As for the financial statement standards presented here, content-wise they conform to the regulations of the Securities and Exchange Commission, and hence apply to financial statements intended primarily as financial reports to that commission. The concern of this investigatory committee did not end there however. From a wider point of view, we recognized a need to consider those businesses not coming under the Securities and Exchange Act. Although the concrete features of such financial statements themselves will be prepared in accordance with these accounting standards, it is probable and necessary that different formats be prepared for different objectives in mind other than the Securities and Exchange Commission. In which event, it has been proposed as feasible for this committee in the future to also suggest revisions to, say, the Commercial Code or the tax laws. Be that as it may, it was necessary to distinguish between the ideals and realities of this question, or else these standards would never have assumed concrete shape. For this reason then our target was tentatively limited to matters coming under the Securities and Exchange Act [1949, p. 32].

After four years of silence due to the war, the Japan Accounting Association held its Seventh Convention in May

1948. The roundtable discussion on the theme "Improvement and Unification of Financial Reports" addressed the problem of whether the goals and objectives of the balance sheet are in fact "single" or "multiple." On this subject, the master of ceremonies, Iwata, expressed the following opinion:

> . . . but what has to be considered here is *Who* is actually going to utilize the financial statements in question. The addressed parties may include long-term or short-term creditors, or shareholders, or the Government. Among these groups of creditors, banks are naturally by far the most important and most affected group. Banks, however, are not satisfied with financial statements and usually dig deeper than that. The Government, e.g., tax authorities, has the right to ransack account books, if it is not satisfied; general investors had the same rights but in actuality they could not or do not normally exercise their powers. For various reasons, such as being geographically remote or normally out of touch with the company in question, they are insufficiently influential or not given the opportunity to enter the premises to check the books. The weakest class of creditors and shareholders, i.e., general public investors should, I think, be given the first priority in receiving protection. . . . In this light, I believe, corporate financial statements are now prepared and issued at each accounting period for the benefit of the public investors including shareholders and corporate debenture holders [1949, p. 65].

FACTORS THAT CONTRIBUTED TO JAPAN'S ACCOUNTING REVOLUTIONS

As we have seen, Japan experienced two revolutions in accounting, one in the latter part of the 1800s, and the second after World War II. The revolution in the latter part of the 1800s was a change in bookkeeping methods (i.e., the introduction of Western-style double-entry notation). Such methods, as clearly set forward in the first manuscript published by Pacioli in 1494, finally arrived in Japan after nearly 400 years. Double-entry bookkeeping subsequently served as the foundation upon which the modern capitalist economy of Japan could develop. The postwar accounting revolution changed the style of financial reporting and involved a shift in emphasis in all facets of accounting thought, practices, and institutions from stewardship-oriented accounting to accounting directed toward public investors. Through the implementation of this change, Japan was fully outfitted with the various structures making possible the disclosure of financial information, and the idea of making the so-called absentee investor the central figure among recipients of financial information became firmly implanted in Japanese accounting thought. In addition to contributing to the development of the stock market as a place for generating industrial capital, this shift in emphasis in financial reporting also served to greatly stimulate the then-exhausted Japanese economy.

Among the factors that contributed to these two accounting revolutions in Japan, the author recognizes two that were common to both: (1) the fact that Japan's level of economic development lagged behind that of the West, and (2) the creation of new political, economic, and cultural entities by an external force. The first of these was the major cause of the revolutions; the second served as their trigger.

Because accounting develops in response to the needs of the environment or society, accounting revolutions come about as part of changes in the social economic structure. In 1873, at the time double-entry bookkeeping was adopted by the newly established First National Bank, Japan was just awakening from a long period of political, economic, and cultural isolation. Capitalist industrialization had not yet matured, and merchants and businessmen were using accounting methods that were largely unsatisfactory. In 1945, at the end of the war, when Japan began its economic recovery, the stock market did not function as a place for generating industrial capital, and thus the entire structure of business accounting was severely handicapped.

When nations of different levels of economic development come into contact, it is only natural that the nation lagging behind will begin an effort to reduce the difference between itself and the more advanced nations. The two accounting revolutions in Japan were the result of just such a catching-up process. At the same time, however, movements to revolutionize existing practices and institutions encounter a certain amount of resistance or a movement to preserve the status quo. Thus, most changes and improvements that occur do not do so overnight but occur, in fact, gradually.

For this reason, it was necessary that some sort of external force trigger a revolutionary change in accounting practices so that institutions could keep pace with the change in accounting thought. In the latter part of the 1800s, this force appeared in the form of advanced capitalist nations that, having experienced the industrial revolution and possessing tremendous productive capabilities, came banging on Japan's door demanding free trade agreements. In order to remain an independent nation on an equal footing with these other capitalist giants, Japan was forced to undergo rather rapid political, economic, and cultural modernization. After World War II the Allied Command occupying Japan served as a force to trigger change. Without this outside force, it seems unlikely that Japan could have broken up the Zaibatsu conglomerates or adopted a policy of economic democracy in which industrial capital is widely dispersed throughout the public sector.

THE FUTURE OF ACCOUNTING IN JAPAN

Since the end of World War II, the Japanese economy has undergone tremendous development, but it is the author's opinion that the accounting structure in Japan has not kept pace with its own economic growth. For example, the practice of publishing interim financial statements as part of the financial reporting of a business was adopted only ten years ago, and consolidated financial statements have only recently been required. As of yet, cash flow statements and value-added statements are not included among published financial statements. Although Japan ranks economically among the leading nations of the world, its financial reporting is inadequate. Will a third accounting revolution be required to close the gap? The author does not think so, although an analysis of modern Japanese accounting history might tempt one to reach such a conclusion. The difference between Japan's two earlier revolutions and the present situation is that both revolutions were preceded by periods of Japanese isolation from the rest of the world. Today, such isolation is no longer possible. That is to say, advances in transportation and communication technology, together with an increasing tendency toward international cooperation, make it increasingly unlikely that individual nations will conduct economic activities independently and completely apart from worldwide economic activities. Differences in the level of economic development will eventually even out, and adjustments to new economic conditions will be gradual and more evolutionary.

Should any future revolution take place, it would doubtless be international in nature, occurring in response to specific technological innovations. Since the end of the 1960s, an international revolution in financial reporting with economic income measurement giving ground to an informational approach, has been in progress. In Japan, there also has been much interest in this informational approach, but as yet there is little evidence that this approach soon will replace economic income measurement. A more likely scenario is one in which ever-increasing foreign investment in Japan and Japanese investment abroad will force a gradual but definite evolutionary change or adaptation upon the accounting structure in Japan. Future development of Japanese accounting will be of special interest to accounting historians as international investment patterns involving Japan become more complex.

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