THE ACCOUNTING REGULATIONS IN THE REVISED JAPANESE COMMERCIAL CODE

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I

The regulations governing corporations in the Japanese Commercial Code were greatly revised in 1962. The purpose of this article is to clarify the fundamental characteristics of the corporate accounting regulations contained in this Revised Commercial Code.

Corporate accounting procedures are regulated by laws in order to accomplish the following two main objectives. The first is to assure sufficient financial information for stockholders and other interested parties so that they can assess accurately the financial position and the operating results of a company. The second is to assure distinction between the disposable and the undisposable part of corporate properties, in other words, determination of the available income. This latter objective is of great concern to the corporate creditors since their only collateral resource is the corporate properties as stockholders enjoy limited liability. Any impairment of corporate properties resulting from dividend distributions in excess of the available income harms the interests of creditors. "The Regulations concerning Corporate Balance Sheet and Income Statement"[1] relate to the first objective mainly by controlling the form of financial statements. The accounting regulations in the Commercial Code, on the other hand, relate to the second.

The maximum amount available for dividends can be determined in accordance with the regulations of the Revised Commercial Code (Art. 290–I) by application of the following formula:

> Maximum amount available for dividends=(Assets−Liabilities)−(Capital stock+Legal capital reserve[2]+Legal income reserve, including the amount to be added for the period concerned[3]) ....(1)

Most of the articles in the Commercial Code, which regulate corporate accounting, specify the factors to be considered in determining the values of the assets, liabilities, etc. to be used in applying this formula. They are Art. 285–2 and certain other articles subsequent to it (asset

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[1] An ordinance of Ministry of Justice complementary to the Commercial Code. It has been put in force in 1963. In the following pages it is called "the Commercial Code Regulation" for short.

[2] Art. 288–2 provides that the legal capital reserve consists of the following four items:

(1) paid-in surplus arising from issuance of par-value stock,
(2) paid-in surplus arising from issuance of no-par-value stock,
(3) surplus arising from a reduction of legal capital, and
(4) surplus arising from merger.

[3] Art. 288 provides that the corporation must retain its earnings as legal income reserve at least as much as 10% of every cash dividend, until it amounts to 25% of the capital stock.

valuation and items to be shown as assets), Art. 287-2 (items to be shown as liabilities), Art. 284-2 (capital stock), Art. 288-2 (legal capital reserve) and Art. 288 (legal income reserve). It can be said, therefore, that most of the articles relating to corporate accounting regulate the determination of the maximum amount available for dividends.

Furthermore, we can point out another example that the commercial law[4] takes the determination of the maximum amount available for dividends seriously. It is the income statement provided in the Commercial Code Regulation. According to the Regulation the amount of retained earnings voluntarily reserved for a particular purpose, when no longer required for such purpose, must be shown on the income statement as a special gain. The result is that income statement includes an amount which has previously been included in periodic income. This is the reason why the income statement provided in the Commerciel Code Regulation is denounced as "strange", "eccentric" or "absurd". According to the principles of modern accounting, a major objective of which is the proper determination of periodic income, it is quite unreasonable to show a part of prior years' earnings in the income statement. In the Commercial Code Regulation it is nevertheless actually provided that such a part of prior years' earnings be shown again in the income statement. The income statement prepared in this manner might surely look strange, eccentric or absurd in the light of principles of accounting. But we should keep ourselves from condemning such a statement as unreasonable only for this very fact. Everything has the reason for its existence. It is important here, therefore, to ask why the Commercial Code Regulation provides or requires such an income statement and to make clear the basic principles of the Commercial Code Regulation.

Suppose that the board of directors has decided to get rid of the reserve for construction as the construction is completed. This reserve, legally distributable but voluntarily restricted, is then returned to the unappropriated retained earnings and added to the amount to be disposed of at the general meeting of stockholders. It is such an amount that the income statement in the Commercial Code Regulation intends to show. It is the amount which is legally available and which is to be disposed of at the general meeting of stockholders. In other words, the income statement in the Regulation should be called as a statement of amount available for dividends and it is not the income statement in the common accounting sense. If we understand the nature of this income statement rightly we can not simply condemn the article of the Regulation, which provides to show the reserves returned as gain items in the income statement. The only point to be questioned is that the Regulation has called such a statement "an income statement". It is by no means an income statement in the common accounting sense.

Apart from the unsuitableness of terminology, the income statement in the Commercial Code Regulation, a statement unfamiliar to the traditional accounting practices, could be regarded as good evidence that the commercial law takes the determination of available income very seriously.

[4] The term "commercial law" is used here as a general concept. It includes concretely both of "Commercial Code" and "Commercial Code Regulation."

II

Now we should like to inquire about the distinctive characteristics of the Revised Commercial Code articles regarding the computation factors of the maximum amount available for dividends by the above formula (1), particularly in regard to assets and liabilities.

The first characteristic to be pointed out is the adoption of the acquisition cost basis as a principle of asset valuation (Art. 285-2-I, 285-3-I, 285-5-I and 285-6-I). Compared to the old provisions, in which inventories were valued on the less-than-market-price basis and the resulting appreciation gains could be included in available income, the adoption of the cost basis in the Revised Code means a drastic change in the valuation principle and it has made the Revised Code approach the principles of accounting. The only explicit exception to the acquisition cost basis is the write-up of the book value of bonds acquired at a discount (Art. 285-5-I proviso). But this is not "an exception" to the cost basis in its true sense, because it means a write-up resulting from financial revenue that must be distinguished from appreciation gains.

While the Revised Code prohibits the recording of appreciation, it requires a devaluation or a write-off of all or a portion of book values of assets in the following cases. They are where market prices of inventories and marketable securities are markedly lower than their acquisition costs and the recovery to the acquisition costs can not be expected (Art. 285-2-I proviso, 285-5-II and 285-6-II), where depreciation of fixed assets is required (Art. 285-3-I), where fixed assets are damaged unexpectedly (Art. 285-3-II), where receivables and unmarketable bonds are likely uncollectable (Art. 285-4-II and 285-5-II), where the net worth of the issuing corporation of unmarketable stock has been markedly impaired (Art. 285-6-III), etc. In addition, the devaluation or write-off of the book value is permitted even where the decline in the market prices of inventories and marketable securities is insignificant or where the decline is significant but the recovery to the acquisition cost can be expected (Art. 285-2-II, 285-5-II and 285-6-II).

The extension of the scope of deferred assets legally allowed is the second characteristic of the Revised Code. According to the old provisions only four deferred assets were expressly permitted to be deferred. They were organization expense, stock-issue cost, bond discount and interest during construction. There were certainly differences of opinion among the lawyers as to whether other deferred assets than those four were lawful or not. The majority was, however, of negative opinion on the ground that they are fictitious, not true assets, having no cash or realizable value and that they are thus only exceptionally allowed to be deferred for the necessity in legislative consideration.

In addition to these four, the Revised Code admits expressly to defer bond-issue cost (Art. 286-5), preliminary expense (Art. 286-2), development expenses and experimental and research expenses (Art. 286-3). In this point the accounting regulations in the Revised Code should be considered to have approached remarkably the principles of accounting.

The third characteristic of the Revised Code is that it has newly admitted the creation of the allowances "for specific future expenditures or expenses" (Art. 287-2). It could be considered as a first step toward the general acceptance of liability reserves by the commercial law and as a great merit of the Revised Code from the viewpoint of accounting.

III

How should we appreciate these characteristics of the Revised Code; the acquisition cost basis in asset valuation, the extension of the scope of deferred assets and the acceptance of the liability reserves?

The theoretical ground for acquisition cost basis lies in that some of the assets are regarded as future expenses or past money and not as goods or future money. Realizability is, therefore, the indispensable character not to all assets. It is only from such a standpoint that the deferred assets of no realizable value are regarded not as fictitious but as true assets just like inventories and depreciable assets.

On the other hand the ground for creation of such liability reserves as the allowances for repairs and so on, which do not represent legal liabilities, lies in that expenses are not allocated properly to the periods if the expenses represented by the liability reserves are not taken into account in advance. Without creation of liability reserves a proper matching of expenses and revenues is not attained and consequently the proper determination of periodic income can not be expected.

In these respects we can see an approach to and an adoption of the principles of modern accounting, as the proper determination of periodic income is one of the major concerns in accounting. So far the last revision of the Commercial Code deserves admiration.

The accounting regulations in the Revised Code, however, do not completely correspond to the principles of accounting. Many discrepancies exist still between them. We can point out an example of discrepancies in the security valuation. According to the principles of accounting, securities are valued from the viewpoint whether they are held temporarily or for a long period. According to the Revised Code, on the other hand, they are classified into marketable and non-marketable securities and valued corresponding to this classification.

Difference in the interpretations of the nature of deferred assets is the more fundamental discrepancy between the Revised Code and the principles of accounting. The scope of deferred assets is, as indicated above, remarkably extended in the Revised Code and bond-issue cost, preliminary expense, development expense and experimental and research expenses are newly admitted to be deferred. But this extension of the scope of deferred assets in the Revised Code does not mean that these deferred assets are regarded legally as true assets just like cash, commodities, etc. They are still regarded, as in the Old Code, as fictitious assets and are only exceptionally admitted to be deferred. Such an interpretation of the nature of deferred assets in the Revised Code can be confirmed by an article requiring a special treatment of deferred assets, especially those newly admitted, in the determination of the maximum amount available for dividends. The article provides; when the total amount of deferred preliminary expense, development expense and experimental and research expenses exceeds the total of legal capital reserve and legal income reserve (including the amount required to be added for the period concerned), the difference must be deducted from the amount available for dividends, which is calculated by application of the formula (1) (Art. 290-I). Other deferred assets, such as organization expense, stock- and bond-issue costs, etc. are not treated in this manner only because they are practically not material in amount.

It is often said that the last revision of the Commercial Code has made its regulations for deferred assets approach the principles of accounting. Such an opinion, however, comes from a superficial interpretation of the Revised Code and we can not support it.

How should we then appreciate the asset valuation regulations in the Revised Code? The adoption of acquisition cost basis by the Revised Code means, as mentioned above, an approach to the principles of accounting. On the other hand this valuation basis has an effect to prohibit the recognition of appreciation gains resulting from market price valuation, which was allowed in the Old Code. The valuation regulations in the Revised Code are, therfore, more effective to the maintenance of corporate properties and thus contribute much more to the protection of interests of corporate creditors than those in the Old Code where the appreciation gains were included in the available income. Recognition of valuation loss or write-off of all or a portion of book value, which the Revised Code requires or allows according to the circumstances, contributes also to the maintenance of corporate properties and to the protection of creditors' interests.

The same effect can be recognized in the creation of liability reserves newly admitted in the Revised Code, because it reduces the maximum amount available for dividends. Moreover, some lawyers are of opinion that the reserves to be deducted in the determination of available income include not only the liability reserves but also the reserves set aside from income. According to this opinion, the maximum amount available for dividends decreases still more.

IV

In the Revised Commercial Code, just as in the Old Code, only the realizable assets are regarded as true assets, while the deferred assets as fictitious assets. If the assets are to be limited only to the realizable assets, they should be valuated as a principle on the basis of realizable value as were in the Old Code. Nevertheless, the valuation basis in the Revised Code is the acquisition cost. How can it be explained and what is the ground for it? The only reason why the Revised Code adopts the acquisition cost basis is that it prohibits the recognition of appreciation gains and thus agrees with the thought of protection of creditors' interests, one of the basic thoughts in the commercial law. The liability reserves are also admitted in the Revised Code for the same reason.

We can surely recognize that the accounting regulations in the Commercial Code have through the last revision remarkably approached the principles of accounting at least superficially. But this approach has accomplished only because it contributes to the protection of creditors' interests.

One of the basic thoughts of commercial law, "protection of the creditors' interests", which is traditional in this field since the Ordonnance du Commerce of 1673, has been promoted in the Revised Code by the adoption of the principles of modern accounting.