

Accounting Standard for SMEs in Japan

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Abstract

The first accounting standard for SMEs in Japan was established in 1949. This is called “Book Keeping Guidance for SMEs”. It was established soon after World War II at the request of the Shoup Mission of the US. Since that time, an accounting standard for SMEs, appropriate for current situations has not been established. After the bursting of the bubble economy in Japan in the early 1990’s, SMEs could no longer borrow funds from financial institutions on real-estate mortgages or collateral. Financial institutions began to focus on the profitability of SMEs, and an appropriate accounting standard became necessary.

For these reasons, “The Guideline of Accounting for SMEs” was published on August 1, 2005. However, this Guideline is not used as widely as was originally expected. Because the idea of single standard narrows the range of choice for accounting treatments, it is a burden for many SMEs to make full use of “The Guideline”. Therefore, “The Basic Guidance of Accounting for SMEs” was published by the Small and Medium Enterprise Agency and Financial Services Agency on February 1, 2012. Accounting treatments are simplified more in “The Basic Guidance” than in “The Guideline”. However, the current situation where two accounting standards exist together brings new confusion to accounting practices in Japan.

In this paper, the reason for the co-existence of two accounting standards, their characteristics, and the future trends in accounting standards for SMEs in Japan are discussed.

Keywords: The Guideline of Accounting for SMEs, The Basic Guidance of Accounting for SMEs, Scoring, Financial inspections manual, CRD data

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1 Introduction

The first accounting standard for SMEs in Japan was the Bookkeeping Guidance for SMEs introduced on December 26, 1949ⁱ.

Thereafter, among the several accounting standards, including those based on business law (Companies Act)ⁱⁱ, the Securities and Exchange Act (currently known as Financial Instruments and Exchange Act) and the tax law accounting focused on the definite-settlement-of-accounts principle-based tax law within the framework of the business law (currently known as the Companies Act).

1.1 Necessity of accounting standard for SMEs

After the bubble economy in Japan burst in the early 1990's, SMEs could not borrow more funds from financial institutions on real estate mortgages or collateral. Financial institutions began to focus on the profitability of SMEs, which means that banks started to use financial statements for SMEs. Thus, an appropriate accounting standard became necessaryⁱⁱⁱ.

Recently, there has been a strong tendency among financial institutions to lend funds to SMEs not through real estate mortgages, but based on their profitability. For SMEs to gain the trust of and borrow funds from financial institutions smoothly, and for the management of SMEs to understand the financial condition of their own firms, an appropriate accounting standard is necessary.

The reason for the necessity of presenting financial statements is to provide current and future profitability.

1.2 Background of the establishment of Japan's accounting standard for SMEs

For this reason, 3 major agencies established different accounting standards. On June 28, 2002, the Small and Medium Enterprise Agency set up "The research Group on Accounting standard for SMEs" and published "The Report about The Accounting standard for SMEs". On Dec. 19, 2002, the Japan Federation of Certified Tax Accountant's Associations published "The Research Report of Accounting standard for SMEs". On June, 2, 2003, the Japanese Institute of Certified Public Accountants published "The Research Report of Accounting Concepts for SMEs".

The presence of three different accounting standards led to confusion among SMEs regarding appropriate accounting practices. Consequently, these three public organizations resolved the differences in accounting practices among the three standards and the Guideline of Accounting for SMEs was published in August 2005^{iv}. Then, the three accounting standards needed to be unified.

1.3 Current situation about the adoption of the Guideline of Accounting for SMEs

The Guideline of Accounting for SMEs was not used as widely as was originally expected^v. Awareness in SMEs remains at the same level and did not increase for five years from the publication.

The adoption rate of the guideline has also not improved, as the rate of firms “making financial documents completely based on the guideline of Accounting for SMEs” was below 20%. Only the usage rate of financial support measures like allowances by Federation of Credit Guarantee Corporations has increased. It was revealed that tax accountants and certified public accountants did not recommend the guideline to their clients and many SMEs were not even informed about the guideline itself by tax accountants.

1.4 Reasons for the low adoption rate of the Guideline of Accounting for SMEs^{vi}

There could be two types of reasons for the low adoption rate of the Guideline of Accounting for SMEs, “reasons related to the attributes of SMEs” and “reasons related to accounting standards”

“The reasons related to the attributes of SMEs” could be things like, “limited ties to financial institutes, the unity of ownership and management”, the lack of knowledge about accounting and “the low number of accountants”.

“The reasons related to accounting standards” could be things such as, “separation from tax accounting”, “narrow range of options for accounting processing”, and “cost of changing of the accounting standards”.

1.5 Development of the Basic Guidance of Accounting for SMEs

Responding to the International Financial Reporting Standards (IFRS) has become a problem in SMEs. The Guideline of Accounting for SMEs was at least influenced by the IFRS and it was difficult for SMEs to respond to the measurement of fair value, comprehensive income, etc. Stipulated in IFRS. Thus, arose the need for an the accounting standard which reflects the accounting practice in SMEs^{vii}.

Project history of the accounting standard for SMEs in Japan is discussed in Figure 1.

Figure 1: The background to the development of the accounting standard for SMEs in Japan.

March,2002~ June,2002	The Study Group of Accounting Standards for SMEs was established by the Small and Medium Enterprise Agency (SMEA) . The study groups had 7 meetings. (March 11, 2002, March 29, 2002, April 22, 2002, May 10, 2002, May 22, 2002, June 7, 2002, June 21, 2002.)
June 28, 2002	Press Releases on “The Report about The Accounting standard for SMEs” were published by SMEA.
December19, 2002	“The Research Report of Accounting standard for SMEs” was published by Japanese Federation of Certified Tax Accountant's Associations (JFCTAA).
June 2, 2003	“The Research Report of Accounting Concepts for SMEs” was published by the Japanese Institute of Certified Public Accountants (JICPA).

July, 2005	The Company Act was enacted.
August1, 2005	“The Guideline of Accounting for SMEs” was published by JFCTAA, JICPA, the Japanese Chamber of Commerce and Industry (JCCI) and Accounting Standards Board of Japan (ASBJ).
February 1, 2012	“The Basic Guidance of Accounting for SMEs” was published by SMEA and Financial Services Agency (FSA).

Source: SMEA (2002),*The Study Group Report ,The Accounting standard for SMEs*. SMEA (2002),*The Summary of The Accounting standard for SMEs*. SMEA and FSA (2012), *The comment letter of “The Basic Guidance of SMEs”*. SMEA (2002), *The Report about The Accounting standard for SMEs*. JFCTAA (2002),*The Research Report of Accounting standard for SMEs*. JICPA (2003),*The Research Report of Accounting Concepts for SMEs*. SMEA and FSA (2012),*The Basic Guidance of Accounting for SMEs*. Giichi,Yanagisawa (2003),65-68.

Figure 2: The contents of the report reflected in “The Guideline of Accounting for SMEs”(○ is given to the report reflected.)

The name of report	SMEA	JFCTAA	JICPA
	The Report about The Accounting standard for SMEs	The Research Report of Accounting standard for SMEs	The Research Report of Accounting Concepts for SMEs
Description of SMEs (small and medium-sized enterprises)	(Small Companies on the business law)	○ (Small and medium-sized enterprises)	○ (Small and medium-sized enterprises)
The policy of accounting-standards setting (Single standard)	○ (Single standard)	(Double standard)	○ (Single standard)
Financial Instruments (Arbitrary application of an amortized cost method)	○	○	
loan losses (Recognize when recovery non-ability becomes clear)		○	(○)
allowance for doubtful accounts (Arbitrary application of treatment based on the Securities and Exchange Act)		○	(○)
Valuation of securities (Application of treatment based on the Securities and Exchange Act)		○	○
Impairment loss of securities (Arbitrary application of treatment based on Tax Law)		○	○
Inventory (acquisition cost)		○	

Inventory (Arbitrary application of last cost method)		○	(○)
Depreciation of fixed assets (Arbitrary application of treatment based on Tax Law)		○	(○)
Software (Arbitrary application of treatment based on Tax Law)		○	
Retirement benefit (Arbitrary application of simplified treatment)	(○)	○	
Deferred tax asset or deferred tax liability (Arbitrary application of omitted treatment when it has no importance)		○	

Source: SMEA(2002),*The Report about The Accounting standard for SMEs*. JFCTAA (2002),*The Research Report of Accounting standard for SMEs*. JICPA (2003),*The Research Report of Accounting Concepts for SME*. JFCTAA, JICPA, JCCI and ASBJ (2005),*The Guideline of Accounting for SMEs*.

Each of the three different accounting standards for SMEs has different accounting treatments.○means that accounting treatments are applied by the guideline. The guideline tends to apply the JFCTAA’s accounting standard based on tax law.

There was strong demand for an accounting standard which reflects the accounting needs of SMEs. On Feb 1, 2012, “The Basic Guidance on Accounting for SMEs” was published by SMEA and FSA^{viii}.

2 Usage of the accounting standards for SMEs and actual financing in SMEs

In theory, it is thought that both the Guideline of Accounting Standard for SMEs and the Basic Guidance of Accounting for SMEs are used and these two guidelines co-exist. The aims of the publication of both guidelines are to “help managers to understand the financial health of their firms, make the financial health of their firms clear for the financial institutions and allow SMEs to get financed smoothly” and “set out the financial documents to the financial institutions such as banks, make them understand the future profitability and the health of management and get financed”.

In order to clarify how the accounting standard for SMEs is actually used and how it was utilized in the investment decisions, hearing surveys with tax accountants, financial institutions, and Federation of Credit Guarantee Corporations were conducted.

2.1 Hearing surveys

Hearing surveys were conducted with four tax accountants, two financial institutions, and two members of Federation of Credit Guarantee Corporations. From the surveys, it was found that these points below were considered to be important in the financing to SMEs.

- 1) Financial inspections manual, additional volume [financing to SMEs]
- 2) Scoring

- 3) Whether there are assurances from Federation of Credit Guarantee Corporations or not.
- 4) Management plans, and the personality of managers

Thus, we will discuss how the Basic Guidance of Accounting for SMEs is utilized in regard to these points.

2.2 Financial inspections manual, additional volume [financing to SMEs]^{ix}

Financing is decided based on the “Financial inspections manual, additional volume [financing to SMEs]”. In FSA audits, checks are carried out as to whether the financing is based firmly on the manual.

The “Financial inspections manual”, published in April, 1999, was for major firms, and the quantitative analysis based on this manual resulted in a reluctance to provide new loans and efforts to cut back on outstanding loans against SMEs. Thus, the manual for SMEs,” Financial inspections manual, additional volume [financing to SMEs]”, was published in June, 2002. The manual contains a quantitative analysis which reflects the special contexts of SMEs.

The future profitability of SMEs and the amount of management’s personal assets for security are checked in the financial inspections manual and if there is enough security, financing is conducted. Thus, the Basic Guidance of Accounting for SMEs is considered to be effective in analyzing future profitability.

2.3 Scoring by banks

Financial institutions check the ability of debt payment (the amount of security) in the financing to SMEs. This is because if the financial institutions cannot collect their loans, they will be responsible for it. Banks check the quantitative matters (capital-to-asset ratio, current ratio, and cash flow) and the qualitative matters (the quality and morals of management). To evaluate these matters, financial institutions give their original scorings.

Financial institutions make decisions about financing with marked-to-market information, scorings, and the properties of the SME (the quality of the management, the number of employees, the existence of a successor, personal assets, and the detail of fixed property tax).

If SMEs make financial statements based on the Basic Guidance of Accounting for SMEs, they might be able to reduce corrections and the statements might be effective in evaluating the quality of the management (the properties of the SME).

2.4 A assurances from Federation of Credit Guarantee Corporations

Whether an assurance from a Federation of Credit Guarantee Corporations exists or not is important for financial institutions in deciding on financing. It has a major impact on financing examinations.

Federation of Credit Guarantee Corporations also gives scorings and makes decisions as to whether to give an assurance or not. In the scoring by a Federation of Credit Guarantee Corporations, the score was obtained from the comparison with the average

score from the CRD (Credit Risk Database) data of the firms comparable with the target firm in the target business or the size. Federation of Credit Guarantee Corporations does not take the marked-to market into consideration, but considers the properties of SMEs. They make the decision for the assurance from information about scores based on CRD data, the properties of SMEs, and the financial statements. A financial statement based on the Basic Guidance of Accounting for SMEs is one of the standards for the evaluation in this scoring.

3 Conclusion

From the hearing survey with tax accountants, it was found that the applying the Guideline of Accounting for SMEs was difficult for SMEs and the Guideline of Accounting for SMEs was not used as widely as was originally expected.

It was found that there is a strong tendency to adopt only the Basic Guidance of Accounting of SMEs because the discount for the firms adopting the Basic Guidance of Accounting of SMEs was introduced by Federation of Credit Guarantee Corporations.

The values of the Basic Guidance of Accounting of SMEs were found to be as follows: 1) if a firm adopts the Basic Guidance of Accounting of SMEs, major corrections might be reduced and the quality of the management might be evaluated in the “scoring by financial institutions”, 2) not only the management’s ability with security but the profitability of the firm were evaluated according to the “financial inspection manual” and it is possible that in evaluating the profitability the financial statements which adopt the Basic Guidance of Accounting of SMEs were utilized, 3) in the “assurance by Federation of Credit Guarantee Corporations” the score awarded from CRD data and the accounting statement which adopts the Basic Guidance of Accounting for SMEs were regarded as important.

At first, I was doubtful about the necessity of the Basic Guidance of Accounting for SMEs because I heard that the financial institutions evaluate the marked-to-market and use modified financial statements. However, it was found that in reality the financial statements based on the Basic Guidance of Accounting for SMEs were utilized to evaluate not only quantitative matters but also qualitative matters, such as evaluating scores, personality of the management, management, and profitability.

Scoring was originally invented in order to prevent financing being assessed only by security, a reluctance to provide new loans and the efforts to cut back on outstanding loans by financial institutions.

It is, however, difficult to make a fair decision about financing to SMEs only with the scores relating to quantitative matters. It is rather considered to result in a reluctance to provide new loans and the efforts to cut back on outstanding loans.

Making decisions for financing by considering both qualitative matters like the quality of the management and quantitative matters using financial statements based on the Basic Guidance of Accounting for SMEs, will be a key factor in providing fair financing to SMEs. Further approaches (especially financial ones) might be necessary in order to expand the usage of the Basic Guidance of Accounting for SMEs.

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- ⁱ The project history, needs, and characteristics of Bookkeeping Guidance of Accounting for SMEs and the blue return system were described in Financial Economy Public Relations (newspaper) No. 175 published on February 20, 1950.
- ⁱⁱ In this paper, business law and Company Law are used interchangeably according to the time period under consideration.
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- ^{iv} ASBJ, JCCI, JFCTAA, and JICPA, *Press Release, Establishment of the Exploratory Committee towards the Integration of Accounting Standards for SMEs*, March 23, 2005.
- ^v Ernst & Young ShinNihon LLC, *Actual condition survey in business of small and medium enterprises, Total and the result of analysis*, 2007.
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