

Changes in the Disclosure System and a new wave of Investment Evaluation in Japan A Focus on the Impact of Quarterly Disclosure and IFRS on Japan.

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1. Four topics from the past 10 years

The accounting 'big bang' has promoted the harmonisation of accounting standards since 1998

First of all I would like to review in chronological order the changes in circumstances to the disclosure system that I experienced when I was an analyst. The accounting 'big bang' in 1998 added its weight in accelerating the process of harmonisation of accounting in Japan. As foreign investors heightened their exposure to Japan, capital markets and accounting standards moved towards globalisation. At present, investment evaluation of an internationally diversified portfolio will have a tendency to track an international index such as MSCI Asia Index, rather than a local index such as TOPIX. The total market value of Japanese equity in the Asia & Oceania market is around 50%; however this market share has seen a decreasing trend in recent years. This means that the portion of Japanese equity in Asia keeps decreasing.

This appears to be the same situation that was experienced in the UK around the 1980s and 1990s. In the UK, integrating UK equity with that of European equity markets has become more common, rather than segregation. This process seems to be in connection with the integration of accounting standards in Europe as a matter of course.

Today, the era of online investor relations has arrived, where nobody has any difficulty in accessing IR information from anywhere in the world. This is a very different situation when compared to just 10 or 15 years ago and now requires us to prepare multi-language disclosures in at least six languages to accommodate investors from across the international community—rather than in just two languages such as only Japanese and English.

No need for listed companies to separate individual investors and institutional investors

Many companies target individual investors and institutional investors separately for their IR activity. However this will not be the case in the near future because 'intelligent individual investors' in their own right have come to the fore more than before. I am now in charge of teaching the subject of Business Analysis at my University in which I urge the students to analyse the investment value of a targeted

company thoroughly using publicly disclosed information only. The results were very satisfactory and showed that students with only have a basic knowledge of accounting (70% of the participants were laymen) can comprehend the essence of Business Analysis as an intelligent investor.

Furthermore, this change is also affecting sell side analysts who make their living providing information on companies that is not disclosed in reports. This, coupled with the rise in the buy side analyst, has worked to alter the disclosure system.

Some Degeneration in Disclosure of Consolidated Statements

There are four key points to be considered when looking at the changes and influences of the disclosure system in Japan: (1) Shift to consolidated base; (2) Segment information; (3) Tax deferred accounting and the retirement accounting rule; and (4) Quarterly Disclosure.

(1) Shift to Consolidated base accounting disclosure – Consolidated accounting became full-scale from the financial year starting March 2000 in Japan, which I feel was a little too late. On the other hand I am sorry to say that there are some negative sides to the introduction of consolidated accounting.

For example, the manufacturing cost report was abolished. As you know, fixed cost and variable cost analysis (including but not limited to breakeven point analysis) requires this report. The receivable and account payable report showing major clients disappeared as well. However because of TSE recommendations, most listed companies will disclose management forecasts, whereas in the US, this figure is only two thirds of companies.

Table 1 is the latest P/L of a beer manufacturer in a

Table 1. Manufacturing cost report of beer manufacturer A

classification	notes #	previous financial term from 1/1/2007 to 31/12/2007		current financial term from 1/1/2008 to 31/12/2008	
		million yen	ratio %	million yen	ratio %
I material cost		124,266	67.00	142,225	69.70
II labour costs		10,844	5.90	11,427	5.60
III expenses	#1	50,371	27.20	50,519	24.70
total production cost for the term		185,482	100.00	204,173	100.00
semi-finished goods open inventory		9,234		9,583	
total		194,717		213,756	
semi-finished goods ending inventory		9,583		9,363	
purchases of merchandise for the term		185,133		204,392	
#1					
depreciation and amortization		25,301		26,138	
power charge		2,197		2,154	

Cost calculation method

As our manufacturing process is multiple and consecutive for a single and mass product, the process costing method is adopted.

**Table 2. Amount receivable report
Counter party breakdown**

counter party	million yen
KOKUBU Co.,Ltd.	34,415
ITOCHU-SHOKUHIN Co., Ltd.	22,900
NIHON SHURUI HANBAI Co., Ltd.	11,784
IZMIG CORPORATION	11,434
RYOSHOKU LIQUOR Ltd.	6,995
others*	98,756
total	186,287

*: e.g. HOKKAIDO SHURUI HANBAI Co., Ltd.

Status of collecting and pilling up of the receivable is as below.

balance brought forward from the previous account	additional in the current term	collected in the current term	balance carried forward to the next term	collection rate	average pilling up period
million yen	million yen	million yen	million yen	%	day
200,668	1,320,111	1,334,491	186,287	88	53

#1. Calculation method for the collection rate and the average pilling up period is as below.

Collection rate = (collected in the current term) ÷ (balance brought forward from the previous account + addition in the current term)

Average pilling up period = ((balance brought forward from the previous account + balance carried forward to the next term) ÷ 2) ÷ ((additional in the current term) ÷ 12) × 30 days

#2. Consumption tax is excluded in accounting process. But the amount receivable above is consumption tax included.

**Table 3. Quantitative target of existing business:
Guideline**

(100 million yen)

	2012 guideline	2009 result	changes %	target growth annual average	
Liquor business	9,750	9,855	-105	±0%	
(after liquor tax)	(5,470)	(5,345)	(105)	-	
Beverage business	3,350	2,969	381	about 4%	
Food business	1,150	963	187	about 6%	
International business	1,050	785	265	about 10%	
Sales total	15,600	14,725	875	about 2%	
(after liquor tax)	11,300	10,202	1,098	-	
	2012 guideline	2009 result	changes %	Operating profit ratio target in 2012	2009 result
Liquor business	1,000	785	215	over 10%	8.0%
(after liquor tax base)	-	-	-	over 18%	14.7%
Beverage business	170	80	90	over 5%	2.7%
Food business	60	37	23	over 5%	3.8%
International business	60	-28	88	over 5%	-
Amortization expense of goodwill	-77	-71	-6	-	-
Cost total	1,230	828	402	about 8%	5.6%
Amortization expense of goodwill	1,307	899	408	over 8%	6.1%
(after liquor tax)	-	-	-	about 12%	8.8%
	2012 guideline	2009 result	changes %	target growth annual average	
Profit/loss based upon the equity method	160	99	61	over 15%	
Amortization expense of goodwill	-37	-14	-23	-	
Ordinary profit	1,310	905	405	-	
EBITDA	1,990	1,590	100	-	
Net Profit	650	476	174	-	
Amortization expense of goodwill	764	560	204	-	

Table 4. P/L of the parent company

(100 million yen)

	previous financial term from 1/1/2007 to 31/12/2007		current financial term from 1/1/2008 to 31/12/2008	
	million yen	ratio %	million yen	ratio %
I sales amount				
II cost of sales				
1 opening inventory	11,518		11,098	
2 purchases of manufactured goods for the term	185,133		204,392	
3 liquor tax	461,626		440,694	
4 purchases of merchandise for the term	85,938		83,266	
total	744,217		739,452	
5 transfer to other accounts	5,189		5,460	
6 ending inventory	11,098		11,145	
balance	727,928		722,846	
7 cost of real estates business	1,669	729,597	1,613	724,460
gross profit	301,138	29.2%	295,153	28.9%

parent basis statement. Material cost, labour costs and expenses are disclosed. Table 2 shows the details of Accounts receivable for the same company showing major clients. We can be proud of the level of detailed information required for disclosure by the authorities to analysts over the past 50 years.

Table 3 is data distributed in a shareholders meeting. You can see the item 'sales amount after liquor tax' which is very important for analysts. In 2009, the turnover including liquor tax for the beer manufacturer was 985.5 billion yen, but 534.5 billion yen is the real sales amount after tax. Operating profits from the liquor business are 78.5 billion yen which on the surface means 8.0% as operating profit margin, but 14.7% using the after tax value.

What should be done for Japanese accounting practice in the IFRS age?

As the handling of the liquor tax is a rule that is custom to Japan only, what will happen by introducing the IFRS international system in Japan? If some other companies in the same industrial sector do not disclose this like Japanese companies, this issue will become a big problem.

Table 4 shows the same data on the sales amount after liquor tax in the consolidated reports of the parent company. The liquor tax is available in the P/L of the parent company somewhere inside the 80 page annually reported financial report (*Yūkashōken hōkokusho*) but it is very difficult to find the same data in other companies in the same sector. I feel it is similar to solving a case in a hard detective story; I am sure analysts can find the value, but no doubt that general investors will be unable to make all the possible efforts to find the data - it is not user friendly at all.

2. Merits and Demerits: The Quarterly Disclosure System

Some Japanese companies have excellent voluntary disclosure items on Segment Information

The second point I wish to make is about segment information. Mandatory segment reporting started in Japan in 1999 and as with the case of consolidated statements; it was far later than western countries. Before then the number of companies in Japan disclosing segment reports of their own accord had reached a considerably high level and currently there are a great many companies who actively disclose useful information when compared to their western counterparts.

For example, the segment information presented over page as a cross matrix by area and business classification. To analysts, segment information with separate area and business reports are without meaning. It is not useful until the reports are broken down into more details by crossing them into a matrix with each other. Table 5 shows the matrix infor-

Table 5. Area / business specific cross matrix report in the fiscal year 2009

(100 million yen)

classification	Japan		Asia		America		Europe		Unallocated Corp. Items Inter-segment Elimination		Total	
	Sales	Op. profit	Sales	Op. profit	Sales	Op. profit	Sales	Op. profit	Sales	Op. profit	Sales	Op. profit
glass	1,996	-152	703	-8	646	-117	2,268	-60	-363	-13	5,250	-350
electronics, display	2,672	543	2,814	721	23	-2	0	0	-1,815	8	3,694	1,269
chemicals	1,662	-139	617	66	94	0	93	-5	-130	2	2,337	-77
others	657	20	46	5	4	-5	2	0	-20	1	689	20
unallocated corp. items inter-segment elimination	-401	4	-1	0	-2	0	-3	-	-80	1	-487	5
total	6,586	275	4,180	783	765	-125	2,361	-65	-2,409	-2	11,482	867

Op. profit: operational profit

mation of a major glass manufacturer. The data was released during an explanatory meeting with investors and it makes a very good example.

The third point is about tax deferred accounting and retirement accounting. As the introduction of tax-deferred accounting proceeded, ROE has become almost an investment index for its own purpose. It is also important that retirement accounting is handled in IFRS as the lack of transparent accounting in this regard has caused many serious problems -such as the pension debt that lay hidden in JAL.

Long term investors do not neglect the quarterly disclosures

The final point is about quarterly disclosures. It was forcibly applied in the United States in 1968 and became the standard in Japan in 2007. Let me start by discussing the major pros and cons of the system. Its major pro is that it makes the turnaround of companies easier to manage. In other words, it enables us to react and manage changes in company conditions more quickly. However, its major con could be that it encourages short-termism and high volatility investment behaviour.

I wonder how a sell side analyst would analyse the quarterly financial reports? As there are companies who dutifully disclose earnings estimates on a quarterly basis, the estimates may change throughout the year at different times; for example based on quarterly disclosures in July, October or January. Some analysts analyse quarter-on-quarter together with year-on-year changes in the estimates, but now we have never had more opportunities to judge companies for ourselves based upon the consensus of companies and analysts. I very much feel that most analysts fall into so-called EPS syndrome, and there will be more companies who are confused by these analysts.

I don't want to be misunderstood but I would like to say that long term investors don't neglect the quarterly disclosure system. Some quarterly results may decide the long term trend or show signs of change. I believe that proper disclosure on a quarterly basis by companies will definitely benefit investors who are long term oriented.

More data items provided to analysts

Quarterly disclosure is expanding the frequency and number of data items that are provided to analysts. At the start of each year, not long after the management forecasts are announced in interim and annual estimates, the first quarter financial statement is released, making it easy to see the progress rate together with any possibilities for a potential change in the forecast. It is the same with the second and third quarters, however with the fourth quarter, the annual result will be followed by the next interim and annual forecast.

With earnings estimates, it is said that there are four types of estimates: (1) Management forecast; (2) Analysts' consensus estimates; (3) Individual analyst's estimates; (4) Investor estimates. 'Investor's estimates' cannot be revealed but the other three will often be in close agreement with each other.

There was a case where changes in earnings had been released just six days after the quarterly result was disclosed. Another case involved a reversion to an original estimate following previous upward revision of the annual operational profit in a short period of time. All these things prove that some companies take timely disclosures with too short term a view. Judging from many examples, quarterly results and equity prices have the same trends; or rather appear to move in parallel over the long term for many companies. Analysts have never needed to choose a time basis period to rely on before. If Investors were to consider themselves as a medium of information like analysts, it is not so easy to conclude whether the change to quarterly disclosure has been good or bad. It will not be long before there are more investors who actively use the quarterly disclosure system.

Sell side accounting analysts flourish in Europe

Let us consider what kinds of effects can be expected by introducing the IFRS in Japan. In Europe, the IFRS became the standard in 2005. There is a lot we can learn from these precursors. The most impressive points I have found through my investigation is the earnings made by the Big Four, and the

increase in power and influence of many sell side accounting analysts in the capital markets. Investors who responded to the analysts and followed them have become very wise to the right investments. However there arose one problem which has brought confusion into the concept of profits.

We are familiar with the concept of ordinary profit or net profit. But there are different concepts of profits in the IFRS— that profit must be a single measure based upon EPS or profit before tax. Some say these differences will converge in several years, because of accounting standards introduced before the introduction of IFRS were very similar, and pension accounting was already operational in Europe. Analyst reports from the period 2005-06 show in details how European companies tackled the adjustment to IFRS and how beneficial the changeover has been. In Japan, this switch to IFRS will be around 2015-16 and I believe that like Europe, we can expect only a short gap during the transition period.

3. Introducing the IFRS: Practices and Action Guidelines

There is merit to standardisation, but IFRS itself is not flexible enough

I would like to talk about my views and opinions from the perspective of an outsider from what has been stated about IFRS through interviews.

Firstly there are merits to the integration of accounting standards, but they cannot be common to every industrial category. There are vague and obscure parts to the accounting principles that we learned long ago, such as accrual basis, the realisation basis, the cash basis and the matching principle - matching expenses with revenue rather than when they are incurred.

For example, cash flow statements were invented to supplement the flaws of accrual accounting but it is hard to unify all industrial sectors to something similar to cash basis. The strict enforcement of the matching principle should be expected, however I am worried that asset valuation for R&D costs or for the handling of goodwill will fall far short of the current strict rules regarding the conditions for asset valuation in these cases in order to amortize assets. Rather to say, from the conservative point of view it might be better to drop it from total cost. Then there is confusion about the concept of profit. Although we are not accustomed to the new rules, there are a lot of things that do not fit with the new B/S or P/L.

Fears of a drastic deterioration in the level of disclosure

The IFRS seems to roll out standardisation without considering the degree of economic maturity or custom rules for each individual country in the world. In Japan, the issue of sales recognition is going to be

the biggest problem.

For example, when you purchase a television made by one of the large manufacturing companies in a home-electronics retail store using a credit card. In Japan it is quite normal to process and account for credit card payments at the time of purchase. However in some countries, it is irrational to account for payment at the time of purchase and payment should only be accounted for after the television has been delivered and is in full working order at home. These countries believe that the sales standard should work on this principal. From this point of view, how do you standardise what appears to be an impossible match.

On the other hand from an analysts view point, they do not appreciate flexibility with standards like this. They prefer a single standard for each industrial sector. E.g. a Japanese pharmaceutical company in 2009 had revenue of 1,538 billion yen, its advertising and sale promotion expenses in the Sales, General and Administrative expense was 65.9 billion yen - 4.3% of the total revenue. However another company in the same industry had 842.1 billion yen revenue and 109.8 billion yen for its advertising and sales promotion expenses - a 13.0% ratio to sales. It is difficult to think that for a company in the same industry and the same business model, such a divergence exists, but this is what is happening at present.

The subject of my research concerns comparisons between companies in the same industry across the world. Although there are problems with languages and difficulties in conducting one to one meetings with foreign companies directly, on the whole when compared to Japanese companies, the information disclosed by foreign companies has less quantity and quality. The most worrying change about the implementation of IFRS, as mentioned previous, is the loss of the manufacturing cost report as an accounting standard in Japan.

A focus on the buy side becomes more important with differential disclosure

Let me review the changes that will be made in investment evaluation. Firstly I wish to point out that the basic relationship between equity price and financial results— the central dogma— will never change. Analysts and investors will look to see how earnings estimates and equity price will correlate to the end financial result. I am not sure how long a time lag exists between them but you can be certain that there is someone who is not only monitoring the prices on a quarterly basis, but constantly watching to see if any new incentives appear in the market.

Having looked at precedent cases in Europe, I do not think that investment evaluation will be affected greatly. I have a sample survey which asked institutional investors whether or not they changed their investment behaviour during the transition period to

IFRS in 2005. The answer was 'no' for 70% of respondents. Only around 6% said they had 'completely changed' their behaviour.

In Europe there are many institutional investors that use an individual valuation model based upon DCF. This explains why the impact of the transition was not so profound; many companies maintained their own cash flow statements for target companies that they could evaluate. Naturally, it was only logical for these companies to seek out various other investment strategies during the transition period. Although ironically, their selection using developed processes is turning to more traditional accounting standards such as DCF or DDM (Dividend Discount Model). The data source must be the new B/S, P/L and C/F with at least 5 year estimates.

Fortunately IR activity in Japan, including internet based IR, is the highest in the world. Switching to IFRS might be carried out smoothly without any major problems. I expect that companies are aware of and have addressed different disclosures in their IR activity to target the buy-side and have already anticipated the need to comply with a variety of requests made by different analysts and investors.

The CEO talks passionately, logically and without interruption

I have stated the changes required in investor behaviour as a result of the changes in the disclosure system from the point of view of an investor based on my experiences. From a corporate point of view, an expansion of disclosed items is not welcome because it will definitely lead to a cost-benefit problem. When implementing the quarterly disclosure, there was the belief that the new system would encourage volatility of equity prices and lead to short-termism. But investors are varied enough and short

term investor orientation is not synchronised with the introduction of the quarterly disclosure system; many long term minded and conventional investors exist below the surface. I would like to stress to every industrial company that they should not believe that quarterly disclosure will lead to short-termism.

Improving disclosure in the proper manner is necessary for them to have ideal investors. What I mean when I use the term "in the proper manner" implied that there also exists an improper manner. Especially in the age of online IR activity, the tendency has been to distribute information all too frequently leading to a plethora of rambling information that will continue to cause major problems. What disclosure in the proper manner means is that the CEO can have accountability and convey what they think in deciding the prospective future direction of the management of the company passionately, logically and without interruption.

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He graduated in Commerce from Waseda University, MA in the graduate school from Waseda University and Ph.D from Chuo University. After graduating he became a member of accounting in IBM Japan, before becoming an analyst with Nomura Research Institute and JP Morgan Asset Management (in charge of pharmaceutical sector and others.) He was a managing director at Dresdner Asset Management (now MDAM Asset Management) before becoming Professor of the graduate school of International Management at Aoyama Gakuin University. As a main social activity, he was a consecutively a member of the Accounting Standards Board of Japan, Intellectual Property Research Committee of the Ministry of Economy, Trade and Industry, and test committee of the Securities Analysts Association of Japan.

Nikkei NEEDS

The Nikkei Economic Electronic Databank System (NEEDS) contains over 40 years of the most comprehensive and accurate corporate fundamentals data for Japanese listed companies provided in a consistent format for accurate sector analysis. Corporate financial data in NEEDS will contain all IFRS reports for Japanese companies from March 2010. Corporate Financial Information is available via our FTP data service, NEEDS BULK, our historical data service NEEDS SPOT, or our online data download service NEEDS-Financial QUEST.

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