Japan IFRS Adoption

Opportunity or Cost for Private Equity Fund Managers?

Implementation of IFRS accounting standards in Japan will require private equity funds to fair value their fund assets. Meeting these requirements will help provide valuations that enhance transparency and better position private equity as an asset class. Is the industry ready to take advantage of this opportunity to enable private equity to take its rightful place as part of the core portfolio holdings of all asset allocators?

After several rounds of drafting, public consultation and delay, the Accounting Standards Board of Japan (ASBJ) has published revised *Accounting Standards for Financial Instruments* that embraces International Financial Reporting Standards (IFRS) fair value principles.

ASBJs' goal is to improve financial reporting comparability between domestic and foreign companies, and also provide detailed guidance on fair value measurement that is consistent with its US counterparts - the International Financial Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB).

The new rules are effective from 1 April 2022 following revised guidelines issued in July 2021 that include additional considerations for investment trusts and investments in partnerships. As firms brace for the new accounting regulations, the risk is that asset managers focus on the cost of implementation and lose sight of the benefits that come with adopting fair value practices.

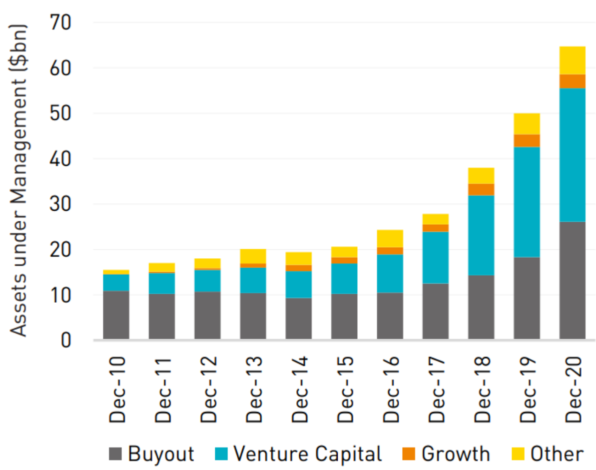
Part I of this report provides a brief historical overview of the investment, accounting, and valuation landscape for private equity in Japan; Part II explores the impact of the new accounting regulations on fund managers.

I. The Japanese landscape

Despite being the world's third largest economy, Japan remains relatively under-served in private equity terms, contributing just 1% of global total deal value. Japan has been reluctant to adopt the private equity model, the roots of which may be traced back to the Meiji period when giant family-owned conglomerates (*zaibatsu*) emerged to control significant parts of the Japanese economy. Even with attempts to dissolve zaibatsu by Allied forces after World War Two, it resurfaced in the form of *keiretsu* whose influence and control over Japanese business remains strong to this day.

In recent years, private equity assets under management (AUM) targeting Japan have reached all-time highs (though still low by global standards). According to Preqin, AUM stood at a record US$68bn as of December 2020 – more than double the total just three years ago. The strong demand from investors is partly due to the attractive risk/return profile the asset class is delivering: a median net IRR of 21%, with a standard deviation of less than 12% across 2008-2018 fund vintages, according to Preqin data. This compares favorably to North America which displays returns of 17% with a standard deviation of 16%.

Japan-Based Private Equity Assets under Management by Fund Type, 2010-2020



Source: Preqin Alternative Assets in Asia-Pacific: Japan (September 2021)

Buyout has traditionally been the most active segment of the private equity market, buoyed by Japan's huge but mostly publicly funded economy that features some of the world's largest companies. Foreign private equity participation has grown, particularly among high-profile carve-outs. In the mid-cap (family-owned SME) buyout segment, business succession presents the biggest opportunity for private equity: declining birth rates coupled with an aging population has led to a lack of successors among business leaders, a trend that has been accelerated by COVID-19 which has spurred many business owners to step down earlier than they otherwise would have.

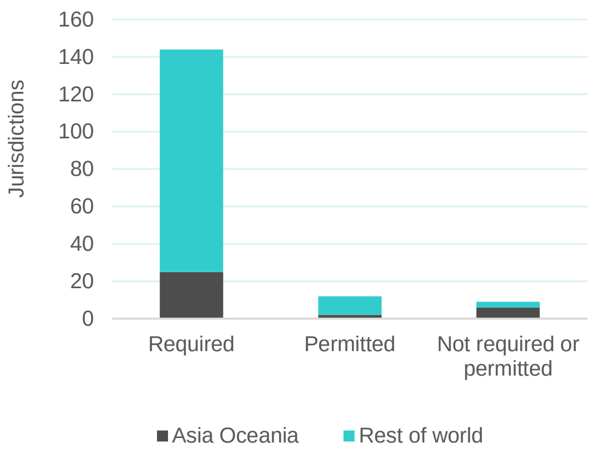
Venture capital investment has doubled in the past three years due to Japan's attractive ecosystem which includes world-class research and development, technological innovation, technology-savvy businesses and consumers, exit routes, and stable political and economic climate.

Overall, the outlook for private equity is positive with deal activity and capital inflows expected to reach new highs in 2022. Competition is intensifying between foreign and domestic private equity firms trying to attract international investors such as endowments and pension funds. The transition to fair value is an important milestone in the evolution of the domestic market that should see corporate Japan accelerate its adoption of the private equity model.

Accounting & Valuation Frameworks in Japan

Historically, Japan has lagged the rest of the world when it comes to IFRS adoption. Out of 166 countries and territories profiled by the IFRS Foundation in 2018, 144 (87%) required the use of IFRS standards, compared to Japan where IFRS has been permitted on a voluntary basis since March 2010. Within Asia-Pacific, notable non-adopters of IFRS include Indonesia, Vietnam, China, and India (though India and China have adopted local accounting standards that are substantially converged with IFRS). Only two jurisdictions in Asia permitted, but did not require IFRS: Japan and East Timor.

Use of IFRS Standards Around the World, 2018



Source: IFRS.org

The four accounting frameworks approved by the ASBJ are shown below. Since 2005 the IASB and ASBJ have been working together to achieve convergence of IFRS standards and J-GAAP. This work was formalized in 2007 with the "Tokyo Agreement".

The Japanese government also promoted voluntary adoption of IFRS as part of its 2018 Growth Strategy Japan. Following this the Financial Services Agency (FSA) has published numerous reports and notices that endorse IFRS. According to the Tokyo Stock Exchange (TSE) only 10 Japanese companies were using IFRS Standards in December 2012. At June 2020 this number stood at 234 companies with a further 172 that had publicly announced they are moving to IFRS.

Japanese GAAP Required by the Companies Act and hence the most widely adopted. Unlike US GAAP and IFRS, J-GAAP requires goodwill to be amortized, making it harder to recognize profits from business combinations.	**IFRS Standards** Not mandatory but may be voluntarily adopted if companies meet certain criteria. More popular among large caps with foreign investors who understand IFRS better than J-GAAP.
Japan's Modified International Standards A modified version of IFRS that retains aspects of J-GAAP. JMIS was created by the ASBJ in 2015 for stakeholders that prefer the conservatism of goodwill amortization, however it has not seen widespread adoption.	**US GAAP** Needs permission from the FSA. Due to the similarities, J-GAAP allows US subsidiaries (reporting under US GAAP) of Japanese groups to be consolidated. There is no such permission under IFRS.

In the asset management world, a recent survey by Preqin and the Japan Venture Capital Association (JVCA) showed that portfolio valuations in Japan follow either local or international standards, or some combination of the two ("GP Discretion"):

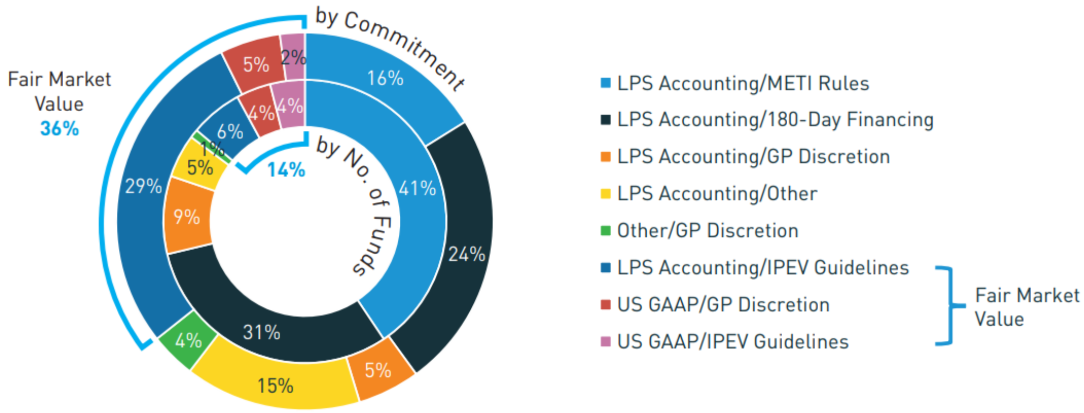
- **International valuation standards**. Valuations are carried out in accordance with IFRS, GAAP and/or International Private Equity and Venture Capital Valuations (IPEV) Guidelines.

- **Local valuation standards**. These include:

  I. *Partnership Accounting Regulations* ("LPS Accounting"). Used by most partnerships in Japan and allows assets to be valued at cost.

  II. *Latest Financing within 180 Days* ("180-day Financing"). JVCA provided this valuation guideline for funds that adopted cost or impairment accounting valuations to allow appropriate write-ups. It allows funds to re-value their NAV based on any transactions in the last 180 days.

Constituent Funds by Accounting Standards/Valuation Guidelines



Source: Preqin Alternative Assets in Asia-Pacific: Japan (September 2021)

III. *Ministry of Economy, Trade and Industry Valuation Guidelines ("METI Rules")*. Widely used by venture capital funds in Japan. Allows assets to be written up using latest financing prices, if deemed appropriate, and to write down based on the lower of the latest financing price or the 'recoverable value,' which is estimated according to the following categories:

- *Rank A – mark at 75% of acquisition price*. Short term concerns about the investment (e.g. business results are worse than expected).
- *Rank B – mark at 50% of acquisition price*. Long term concerns about the investment (e.g. operational results are unlikely to improve).
- *Rank C – mark at 25% of acquisition price*. Need additional financing to recover investment cost (e.g. liabilities exceed assets for three years).
- *Rank D – mark at residual value.* No prospect of recovering investment cost (e.g. bankruptcy).

Source: www.meti.go.jp

The Preqin-JVCA survey results showed that just 14% of funds in Japan comply with international standards compared to the majority (86%) that adopt local standards.

Whilst local conventions such as the 180-Day Financing and METI Rules offer an improvement over the cost approach, they are overly simplistic and result in valuations that fall well short of the accuracy and informational benefits conferred by fair value reporting. For example, under the METI Rules troubled assets could become excessively written down due to the discrete (and arbitrary) thresholds prescribed by the Rules, as opposed to a fair valuation which is more likely to land somewhere in-between the boundaries. Such practices hurt manager performance metrics and could discourage secondary market activity if they form the basis for trading decisions.

II. Impact of new accounting regulations

The new accounting rules issued by the ASBJ will require managers to reassess the value of their portfolios using fair value principles. Unlike J-GAAP which allows unlisted instruments to be measured at cost, fair value under IFRS is the general rule and cost is the exception.

To estimate the fair value of instruments without market prices under IFRS, valuation techniques are required to estimate the *exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*.

In this regard, the historical cost (or amortised cost) may not represent the price that would be received if the investment were sold in an orderly transaction at the measurement date. Equally, cost should not be considered as a "proxy" for fair value. An appropriate fair value exercise which assesses changes in market conditions and investment performance is required at each measurement date.

See Appendix for more details on the differences between J-GAAP and IFRS that are relevant to privately held investments.

Fair valuation considerations for private securities

For funds that invest in unlisted equity (e.g. private equity, venture capital, growth equity) or unlisted credit (e.g. private loans, loan pools, structured products) it is more difficult to determine a fair value because the transactions (if any) take place privately between market participants and are not directly or indirectly observable. Per *ASBJ Guidance No.31 Implementation Guidance*, the determination of fair value for such investments at each measurement date should include the following considerations:

- Identifying the *unit of account* – what is the investment being valued (i.e. entire company or individual shares);
- Determining the *principal market* (i.e. the most volume) or *most advantageous market* (i.e. maximises sale proceeds);
- Applying one or more *valuation methodologies* (i.e., replacement cost, market and/or income approaches);
- Maximising the use of *observable inputs*;
- *Calibrating* inputs used in the valuation; and
- *Backtesting* valuation conclusions.

Private equity valuations are typically performed by determining the enterprise value of the business and then subtracting any outstanding debt. IFRS, US GAAP and IPEV guidelines set forth valuation methodologies and techniques for valuing unlisted equity securities, including the "market approach" and the "income approach", and each has several variations.

The market approach leverages valuation indications provided by transactions in the market involving comparable securities or businesses, and comprises the "guideline public company method" and the "guideline company transactions method". The income approach, or discounted cash flow (DCF) method, develops a valuation estimate by discounting projected economic benefits (free cash flows) at a discount rate that reflects the investors' required rate of return.

Once an enterprise value is estimated, multiple approaches exist for allocating enterprise value to the equity securities within a company's capital structure, including:

- *Current value method* – assigns each equity security a price equal to the greater of its liquidation preference or its as-converted value;
- *Common stock equivalent* – treats all classes of equity as if they converted to common stock and allocates value to various securities based on their fully diluted percentage;
- *Option pricing method* – models each class of equity as a call option on the business, with strike prices equal to the preferred stock's liquidation preferences; and
- *Probability weighted expected return method* ("*PWERM")* – involves projecting future exit scenarios (e.g. IPO, sale, liquidation), estimating the value of each equity security under these difference scenarios, assigning a probability to each scenario, and discounting the probability-weighted prices per share to the measurement date using a risk-adjusted discount rate.

When performing valuations practitioners will also need to consider: discounts (or premiums) for marketability, control, or size; complex capital structures; transaction and exit fees (excluded from fair value); and industry specific business and valuation concerns.

In *private credit* where investments are made based on yield expectations, it is common practice to estimate fair value using an income approach using a market-based discount rate. Determination of a market-based discount rate is often based on the calibration of the implied spread based on changes in credit quality and changes in market conditions (considering comparable market indices or comparable instruments), or built-up by starting with a risk-free rate and adding credit spread components to reflect the security specific risk using market participant assumptions.

An inherent challenge faced in valuing all forms of private credit is selecting an appropriate comparable instrument or index to use to develop a market-based discount rate. The differences in the profile of the issuer, interest rate terms, duration, covenants, and other features, make it nearly impossible to find a perfectly comparable instrument. The on-going credit quality and overall borrower performance of the instrument should be re-evaluated at each measurement date to identify comparable benchmark instruments of similar credit quality.

In cases where investors are evaluating credit investments based on a target recovery (such as for non-performing or impaired debt), fair value may be estimated using recovery analysis of underlying collateral value or the outcome of a restructuring or litigation process. Observable prices, if any, should also be incorporated into the analysis. In certain cases, a PWERM or option-based approach may be useful methods to capture the broad range of possible outcomes.

III. Conclusion

Japan's transition to IFRS is a welcome development that will help the domestic private equity market become more accessible to foreign investors, particularly to large pension and endowment allocators who expect their fund managers to incorporate fair value reporting as part of best practice frameworks[1]. The benefits of fair value also extend beyond accounting as fund managers can use the calculations to provide timely, comparable, and transparent information to their investors which allows them to:

- Exercise fiduciary duty in monitoring deployed capital;
- Report periodic performance to beneficiaries;
- Ensure equitable treatment of investors in subscription/redemption transactions;
- Make asset allocation decisions;
- Make manager selection decisions;
- Make investor-level incentive compensation decisions.

Implementing the new requirements will be a challenging task because private asset valuation is subjective and requires the use of professional judgment, which comes at a cost. However, there is an opportunity for managers to use the disruption caused by IFRS to have some meaningful conversations with their investor base about the challenges they face in their reporting frameworks, and work proactively to put the private equity industry at the forefront of transparency, compliance and robustness.

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Footnote

[1] Valuation best practice typically includes: a written robust valuation policy document; documentation of the key inputs, assumptions and the rationale supporting the conclusion of value; use of an internal valuation committee to provide oversight; and use of third-party service providers to bring independence to the valuation process.

Appendix: J-GAAP vs IFRS

Issue	J-GAAP	IFRS
Classification	Financial assets are classified based on their legal form: securities, bonds, receivables, derivatives, etc.	Financial assets are not classified based on their legal form but according to the definitions of either (1) **fair value** - either through Other Comprehensive Income (OCI) or Profit or Loss (PL); or (2) amortised cost.
Measurement	Unlisted securities are defined as securities whose fair value is extremely difficult to obtain and are measured at **cost**.	Debt instruments are measured at amortised cost if both of the following conditions are met; otherwise, they are measured at **fair value** through OCI or PL: - The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows - The contractual cash flows are solely payments of principal and interest where interest is defined as compensation for time value of money and credit risk Equity investments are required to be measured at **fair value** through PL. Cost may be an appropriate estimate of fair value in rare circumstances.
Impairment	For debt securities which are difficult to measure, a loan loss allowance is calculated based on either (i) historical default experience (normal); (ii) debtors repayment ability (doubtful); or (iii) residual book value (bankrupt). For equity securities whose market value is difficult to obtain, if the net asset value has decreased significantly because of a deterioration in the financial position of the issuer of the stock, the carrying value of the stock is reduced and the valuation difference is accounted for as a loss in the period.	For debt instruments measured at amortised cost or **fair value** through OCI, impairment losses are recognized under the expected credit loss model, i.e. allowances are provided to reflect the 12-month or life time expected credit loss, depending on whether a significant increase in credit risk has occurred since initial recognition. Impairment requirements are not applied to equity instruments since any **fair value** changes are automatically reflected in PL.

Source: PWC: A Comparison of IFRS and JP GAAP, April 2019