

Title	Features of the Japan's audit system
Sub Title	
Author	Yamamasu, Tadahiro
Publisher	
Publication year	1973
Jtitle	Keio business review Vol.12, (1973.) ,p.1- 12
JaLC DOI	
Abstract	
Notes	
Genre	Journal Article
URL	https://koara.lib.keio.ac.jp/xoonips/modules/xoonips/detail.php?koara_id=AA00260481-19730000-03920011

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FEATURES OF THE JAPAN'S AUDIT SYSTEM

by

Tadahiro Yamamasu

Preface

In Japan prior to World War II there was no independent system of audit carried by professional specialists. In those days most of the corporations whose stocks were listed on the securities exchange were under the control of the *zaibatsu*, or financial cliques, with only limited stocks being placed on open transactions. And into these corporations the parent *zaibatsu* companies used to send *jūyaku* (director or the like) to act as supervisor for them. Accordingly it was possible to do without independent audit system charged on professional specialists.

After the War, however, cultivation and fortification of such audit system came to be attached importance, because on one hand a multitude of mass-investors were born as a result of *zaibatsu* resolution and accompanying release of gigantic volume of stocks held to the general public promoted under the name of securities democratization, and on the other hand introduction of foreign capital was required for reconstructing the Japanese economy.

In the below we shall describe the characteristics of Japan's audit system, while making a broad outlook over these circumstances and processes.

1. Audit System by Certified Public Accountant under the Securities and Exchange Act

It was July, 1951 that in Japan an audit certification system by professional specialists, i.e., Certified Public Accountants (*Kōnin-Kaikeishi*) started, which originated in connection with the system of registering statements concerning securities stipulated in the Securities and Exchange Act.

The Securities and Exchange Act might be said to have a nature of, say, special statute to apply to big business as against the accounting regulations in the Commercial Code, general statute. However, it was not a special statute in the sense that it wholly exempted the application of the Commercial Code regulations. In other words, in the case of big business the provisions by the Securities

and Exchange Act had to be complied in addition to the preparation of financial statements pursuant to the Commercial Code regulations.

The Securities and Exchange Act was promulgated in April, 1948 with an aim of effecting smooth circulation of securities which might contribute to healthy management of the national economy and to protection of investors.

And the Act, for this purpose, stipulates that any public offer or sale of a securities brand exceeding 100 million yen can be performed only on registering of such offer or sale by the issuer (or issuer company) at the Ministry of Finance, and for this registration a statement conforming to prescribed requisites and form (called "registration statement concerning the securities") must be filed.

And, by the Act, even after the effectuation of a registration pursuant to the above rules the issuer (or issuer company) must file with the Ministry of Finance a report after prescribed requisites and form (called securities report) for each of subsequent fiscal terms. Furthermore, such securities report must be filed with the Ministry by all issuer (or issuer companies) of those securities listed on a securities exchange or registered as a "brand traded in the over-the-counter market" at the Institutes of Securities Dealers of Tokyo and other cities.

In addition the Act recently has stipulated that when such corporations as are responsible for filing the securities report are adopting annual settlement system a semi-annual report has to be filed; and when such corporations wish to offer or sell securities in foreign countries a report called "auxiliary report" must be submitted to the Ministry.

Thus the duplicates of all these statements and reports must be submitted to the exchanges where the securities concerned are listed or the Institutes of Dealers at which they are registered. In this way the originals or duplicates of such securities are kept in hand by the Ministry of Finance, securities exchanges, Institutes of Dealers as well as home and principal branch offices of the issuer companies, which are made available for public inspection for some length of time in order to serve as basic materials of judgement for investment.

And it is noteworthy that the Act obligates corporations to take audit certification by certified public accountant (or else Audit Corporation, *Kansa-Hōjin*) as regards financial statements that constitute part of the registration statement or report. That is to say, the start of the audit certification by certified public accountants as professional specialists was related with the enactment of the Act.

To add a remark, although more than 1,015,000 joint-stock companies are present in Japan, those subject to the Securities and Exchange Act concern only big firms counting about 2,600. Nevertheless the significance and influence of this system should be considered appreciable in view of the fact that in the case of this Act, as observed already, the focus is placed on those corporations listed on securities exchanges, and hence almost all the representative undertakings of Japan come under the object.

There is one thing to be noticed. That is, banks, trust companies, insurance companies and the like are exempted from the application of this audit certification system for the reason that these undertakings are subject to inspection by inspectors of respective competent authorities. Such exemption, however, should better be abolished in view of the inherent significance of audit certification system. For, true these ways of inspection may also aim at protection of public interests yet it is doubtful whether they alone do suffice to provide protection to investors.

Anyhow, audit certification by certified public accountants is being required to foster public confidence on businesses' financial statements, as a chain of the link of disclosure system of corporation finance which constitutes one of the aims of the Act, and hence the Act has strived to keep confidence of audit certification itself by providing a Ministry of Finance order entitled the Order concerning Audit Certification of Financial Statement.

However, the subjects of this Ministry order are confined to provisions relevant to the scope of financial statements to be placed under audit certification, the standard by which any mutual interest relation between a certified public accountant and the company under inspection be recognized, and the requisites to be stated on audit reports. As regards the standards and procedures of auditing itself, the Order entrusted these to the "Auditing Standards" and the "Working Rules for Conducting Audit," which were published as interim reports of the Business Accounting Deliberation Council, a committee sponsored by the Ministry of Finance.

Thus the Securities and Exchange Act has selected an indirect—double or triple—way of control about the standards and rules to be followed in conducting audit certification, which is not without reason. That is to say, to formulate exhaustively all the procedures of auditing work into the law texts so that they may be adaptable to every case is of course impossible in itself, and furthermore to attempt unreasonable uniformity of instructions and give them legal compulsory power would impede display of ability or use of judgement by auditing persons involving rather a fear of inviting stiffness into audit.

It is true that as to the matters and form of descriptions in the final audit statement substantially concrete rules are provided in the Order itself since some degree of uniformity is necessary to prevent misjudgements by interested persons, yet again in this context much reference has been made to the "Auditing Standards" and the "Working Rules for Preparing Audit Certificate," and the contents are almost common with these regulations.

In short, the "Auditing Standards," "Working Rules for Conducting Audit," "Working Rules for Preparing Audit Certificate" as well as the "Corporate Accounting Principles" (which has been published by the same Council similarly in the form of interim report) are not legal ordinances in themselves but, insofar as the Securities and Exchange Act is concerned, they have been given significance to the utmost degree by the audit by certified public accountant, and on the other

hand this is the greatest reason that makes such audit appreciably up-to-date.

2. Audit System by Auditor under the Commercial Code

As may be seen by the above, almost all big corporations of post-War Japan are placed under the obligation of accounting audit in a double form, that is, by the enactment of the Securities and Exchange Act and by the amendment of the Commercial Code.

To compare audit by certified public accountant by the Securities and Exchange Act and audit by auditor (of the company) under the Commercial Code, we could say:

- (1) while the former aims at pertinent management of the national economy and protection of investors (incl. potential, future stockholders), the latter at protection of stockholders and creditors;
- (2) while the former takes for its object promotion of disclosure of financial matters of business and expression of views on the fairness of financial statements, the latter expression of views on the calculation of profits allotable as dividends and the propriety of statement on financial conditions;
- (3) in the former context independency (of audit) means that between the accountant and the inspected corporation, while in the latter that between the auditor and the executive organs of the corporation including board of directors.

Thus there can be observed some difference between the two systems that reflects respective ends, yet they are identical in that the matters are similarly accounting audit. Notwithstanding this the Securities and Exchange Act has come to charge audit by certified public accountant on big firms in spite of the attempt on the side of the Commercial Code to confine the scope of auditor's task mainly to accounting inspection. Naturally there is a background for this.

That is the tendency that general meetings of stockholders are becoming only nominal and auditor's inspection turning to an empty being. That stockholders' general meetings become nominal in accompany with the expansion of business scale while minority control prevails may be said a natural consequence of the isolation of most capital owners from management, and this poses a situation basically different from labor unions organized by workers who take labor power, another element of management, for the background. Indeed in the big businesses of today such instances are numerous as, contrary to what the laws take ideal, stockholders' general meetings are subject to minority control, changing substantially into a "comic theatre with no audience."

And this fact is one of the reasons why boards of directors were formed in accompany with the growth of reasonable and autonomous systems of management, to which the Commercial Code extensively transferred the competence of stockholders' general meeting. It means again that to the reality, which had been so much isolated from the ideals of laws, the side of system was pulled nearer,

and so far this was possible to be a solution. However, it must be said that thus generally meetings have been almost given up nominally as well as actually (that is, as a system).

Furthermore, in view of the fact that such quantitative separation has proceeded between stockholder masses and general meeting,—the latter being set up as a formal concept, with its interests not always coinciding with the former's—certainly there must remain a question to what an extent such audit by auditor, whose mother's body of selection is general meeting which has changed into a formal being, could perform its function as a system for protecting the interests of general stockholder masses. For this reason we often hear a whisper of "private armies without authority" behind the auditor system.

And in the enterprises of Japan the auditor's post itself is originally very unstable. Actually in many cases this post is utilized as a career-end job, implying acknowledgement or remuneration, for those who have not been selected for director despite long-year service or who have retired from director. Formally he is selected by stockholders' general meeting, yet the general meeting, which has become a nominal being as mentioned above, cannot but unconditionally approve the candidate one-sidedly chosen by chief executives; the competence to decide remuneration for auditor lies in the hand of executives.

Accordingly it was a logical course that in addition to audit by auditor, who had been turned to an empty being isolated from the primary idea of the system, there was introduced anew, at least as regards big business, audit by certified public accountant, an independent third-person plus a specialist, and thus double audit came to be imposed.

3. Adjustment between the Two Audit Systems

By the by, with the appearance of accountant's audit under the Securities and Exchange Act an exceptionally complex problem came to be faced in Japan. That is to say, in the case of corporations subject to the Act double accounting audit, so to speak, became necessary, by auditor and by certified public accountant. Hence there was born an opinion that such double audit should be cleared in some way. This is what was called the "problem of adjustment between audit by auditor and that by certified public accountant," which had been earnestly discussed since as early as 1951–52.

To add a note, the device to set up an organ like auditor in a corporation is said to have its origin in the East India Company (Vereenigde Oost-Indische Compagnie) founded in 1602. This company was managed under a very executive-arbitrary system—just as a miniature of the despotic political mechanism of urban commercial aristocrats (Rogenten) in the country of those days—against which a movement of resistance arose among general investors, leading to the set-up of two audit committees in 1623, Commissie van Heeren Zeventien and Commissie van Hegen. However, it was impossible for such committees to display

the audit function required in those days; the system of auditor showed development later rather in the United Kingdom and Germany in respective ways.

The United States, in inheriting English laws, did not introduce this auditor system excepting instances in a few States. It is taken that this was due to the situation that many States, which had independent legislative power as a federal nation, competed for free and generous legislation in order to invite industries. Hence only audit by accountant under the Securities Act and the Securities Exchange Act as federal laws is seen, bringing about no problem of adjustment between auditor's audit and accountant's.

In the United Kingdom, where the auditor system exists, nowadays eligibility to be an auditor of general public companies is confined to one who is a member of several specified organizations of accountants (Institute, Society, Association), or one corresponding to this. Thus accountant's audit is absorbed into the auditor system of the Company Law, both making two faces of coin.

On the other hand, in Germany in the latter half of last century Verwaltungsrat, which had been existing as a custom, was legalized as Aufsichtsrat, to which thereafter have been entrusted supervision and auditing on directors' business execution and accounting reports. In addition to this, professional inspectors akin to British and American accountants also existed since old days, and especially since the thirties of the century periodical financial audit by Wirtschaftsprüfer or Wirtschaftsprüfungsgesellschaft has become compulsory to all Aktiengesellschaft. So it seems that accounting audit is being conducted in a double way.

However, the said Aufsichtsrat of this country is essentially featured with the nature of supreme organ to hold the real power of management, rather than being an organ for accounting audit, and its status as system is close to board of directors seen in America and Japan. Originally Aufsichtsrat is a word meaning men of real power. Hence between Aufsichtsrat and Auditor there is a remarkable difference of character as system, and there should exist no serious problem of "competitive position of two accounting audit system" as is seen in Japan.

In Japan the auditor system under the Commercial Code whose nature was, until the amendment of the Code after the War, 1950, was akin to German Aufsichtsrat rather than to British auditor. It is because, although Japan's auditor was not given competence so strong as was German Aufsichtsrat, it was admitted to exert supervision or investigation not only on accounting but also on business operation. Under the present Commercial Code, however, the functional competence of auditor is confined mainly to accounting audit. In other words auditor's character is close to that of accounting auditor as in the United Kingdom. The concrete contents of his function may be:

- (1) to supervise firm's management indirectly through accounting records;
- (2) to examine appropriateness of business by the amount of period profit shown in financial statements;
- (3) to investigate propriety of the amount of disposable profit calculated

and its appropriation plan.

4. Movement of Revising the Audit System

As has been pointed out in the above, there lies some difference of aim between auditor's audit under the Commercial Code and certified public accountant's audit under the Securities and Exchange Act, but both are identical in that accounting audit forms the matter. Accordingly there have been active debates on the "adjustment problem" between the two, in which it has been stressed that such parallel enforcement of double audit should be solved, even if the former has been fruitless.

It cannot be denied that among the suggestions proposed there are some status-quo-maintenance views holding that auditor's audit and accountant's audit should coexist, both auditor and accountant taking charge of accounting audit. However, overwhelming are opinions to urge unification, the major ones being:

(1) to abolish the auditor's audit system, leaving certified public accountant's audit alone (namely American type);

(2) to suspend accountant's audit, and rather to pull back the system to the previous one of singular auditor's audit;

(3) to retain auditor's audit itself but to contemplate unification by selecting certified public accountants as auditors (this view is divided into two: one intends to limit persons eligible for auditor to certified public accountants as seen in the United Kingdom today; the other to appoint at least one certified public accountant to auditor as in France);

(4) to retain the auditor system but to charge auditors rather the task of operational audit (this idea is basically different from the status-quo-maintenance argument since its intention is simply to evade the problem of competitive status: it may be said rather close to the above opinion (1) insofar as the aspect of accounting audit is concerned).

These discussions began in about 1951-52 soon after the start of audit by certified public accountants, but gathered earnestness since 1956 when this system was decided to go on its proper rail one year later with the termination of transit measures for easing frictions.

The various proposals presented above have reasonable grounds each, and hence retortion from diversified viewpoints can be seen. Judgement of merits and faults therefore requires cautious examination. Whichever idea was adopted, however, since every device involved some problems that need beforehand schemes to cope with them, it was necessary to solve such problems at the same time if the desired effects of such devices were to be expected.

For these reasons no appreciable conclusion has been reached therefore, and no apparent development has been seen. However, since 1965 several events, including the failure of Sanyō Special Steel, occurred one after another which wakened doubts about the effectiveness of the auditor system anew,

there arose moves on certified accountant's audit towards fulfilment of technical aspects of auditing (e.g., intensification of confirmation of receivables or observation of inventories), consolidation and improvement of audit mechanism (e.g., reinforcement of autonomous control among certified public accountants by reorganizing the Japanese Institute of Certified Public Accountants into a special juridical person with mandatory membership), and promotion of systematic auditing as well as of independence and integrity of work by encouraging partnership of individual accountants. And in conjunction with these moves, the device for adjusting auditor's and accountant's audit came to be rapidly materialized through an angle somewhat different from the past one.

That is, by amending the Commercial Code partially:

(1) to give auditors a sort of operational audit function, i.e., to supervise adequateness of the execution of directors' function, in addition to the accounting audit function stated in the current law, and at the same time to increase strictness in eligibility, requirements for selection and dismissal, and competence of auditors;

(2) as a special case for big corporations, to impose accounting audit by certified public accountant (or their auditing corporation) combinedly by the Commercial Code to corporations capitalized at more than 500 million yen.

These two points have been drawn into a draft, which is expected to pass the 1973 Diet.

According to this plan, not only auditors are conserved and accounting audit by them is conducted as has been formerly, but also, as to big firms, accounting audit by certified public accountants is introduced into the Commercial Code, and this measure does not at once terminate accountant's audit under the Securities and Exchange Act.

Accordingly the improvement proposed in this plan seems to run counter to the line of unification at least apparently. Indeed its appearance is double or triple accounting audit on big corporations, yet in its implication adjustment between auditor's audit and accountant's audit is contemplated fairly concretely. Actually auditors will take charge of operational audit principally and the side of accounting audit be delegated to certified public accountants, thus avoiding meaningless duplicity by the two.

And it is also considered that accountants or the like taking charge of accounting audit under the Commercial Code may conduct audit certification under the Securities and Exchange Act also, and in addition appreciable deliberation is made so that a single audit by the same inspector may satisfy the demand of the two laws to some extent, for instance, unification of matters and form in audit certificates and harmonization of the standards of accounting procedures or preparation of financial statements. Hence the competitive status between audit under the Commercial Code and that under the Securities and Exchange Act will almost completely be avoided in the actual. So this reform, if functioned effectively, will contribute to the improvement of business posture of joint-stock

companies of Japan.

However, for the fundamental solution of firm's audit system itself the legal system must be basically revised. In other words, unless it is determined to enact some independent, single act to summarize the company law, the Securities and Exchange Act, etc. as regards big corporations deserving the name of joint-stock company—on considering to attain more genuineness of stock-companies by removing smaller firms, which account for majority in numbers, into other forms of enterprise—there will be mere repetition of expedient actions as was in the past.

5. Certified Public Accountant of Japan

Next we wish to present some descriptions on the certified public accountant system whose importance is increasing not only in connection with the Securities and Exchange Act but also with the Commercial Code.

The opening of the first accountant's office in Japan was in 1907, that is, an office set up by Mr. Kumatarō Morita of Osaka. In the several ensuing years a number of people appeared who wished to commence activities as accountant, but at that time mostly as side-work with only trifling business, and their social rank was low. It was by the moment of the Japan Sugar Refining Co. case in 1909 that in Japan concern about audit by accountants was first born. This was an event to be named a Japanese edition of the South Sea Subtle Case of 1720 in Britain, which drew public attention to the need of audit by independent public accountants.

Under such environment accountants increased in numbers through the middle of Taishō Era, until in 1920 the Japanese Institute of Public Accountants was organized as the first one of such professional societies in Japan. Later on, with several societies being set up one after another, there arose a movement to institutionalize this profession of accountant, and the Registered Accountant Act was enacted as the first legislation on professional accountants. By this Act, those who had called themselves with a private name of accountant came to be officially titled Registered Accountant (*Keirishi*). At the start of this Act they counted only 214 persons but reached about 26,000 in 1948 when the Act was repealed.

However, the qualifications to this Registered Accountant were very generous, and the activities were actually non-audit work such as bookkeeping, accounting practice or tax consulting, rather than auditing or certifying. So an amendment of the Registered Accountant system had been often discussed among the officials as well as intellectual people of the circles and some studies and researches had advanced, yet the amendment had not been realized, carrying the problem over to the post-War period.

This Registered Accountant Act was repealed by the enactment of the Certified Public Accountant (CPA) Act of 1948, yet this new Act temporarily allowed the registered accountants then carrying business to continue their

work under the same title. This temporary step was rescinded by the amendment of the CPA Act in 1964, and the registered accountant system ended at the end of March, 1967.

The CPA Act enacted in July 1948 was not a simple amendment of the Registered Accountant Act but a purely new law to take place of the old. It was a wishful law designed to give birth to professional accountants featured with high competence comparable with Chartered Accountant of the United Kingdom or Certified Public Accountant of the United States. Accordingly this Act requires, as will be later explained, the qualifications of CPA to be of high level and rigidity as in the both countries, and also domestically seen to be comparable with those of lawyers who were long proud of their authority. And although CPAs were originally designated as the sole expert of for auditing and certifying of financial statements, they were allowed to engage also in investigation and planning of financial matters, service as licensed tax practitioner, and other various management services. The birth of such CPAs brought about a remarkable progress in accountancy in Japan which reached an international level in a short time.

In addition in 1966, as previously mentioned, along with CPAs as individuals, their partnership called Audit Corporation (*Kansa Hōjin*) was also set up which served modernization in the Japanese auditing circles. It was created in order to carry out faultless auditing which was becoming increasingly difficult for accountants as individuals because of ability limits in accompany with the expansion and multiplication of business, while keeping independency as inspector and securing status as accountant and international competitive power.

The Corporation is to be incorporated jointly by five or more CPAs who take unlimited liabilities under the Law. The CPAs comprising a corporation participate in executing audit or formulating audit opinions cooperatively under a unitary principle, and take joint responsibility to the results. And a Corporation is required to submit its financial statements and business reports to the Ministry of Finance.

By the birth of the Audit Corporations Japan's audit system has shown remarkable fulfilment on the side of its actual bearers. As of July 9, 1973 there are registered 4,567 persons as CPAs, 31 as foreign CPAs and 1,192 as Junior (assistant) CPAs, and the partnerships licensed as Audit Corporation count 31.

Among these, the said foreign CPAs denote those who have qualification in a foreign country for a profession corresponding to Japan's CPA, have reasonable knowledge of Japan's laws and ordinances concerning accounting, are approved by the Ministry of Finance, and are registered on the Foreign Certified Public Accountant Roster of the Japanese Institute of Certified Public Accountants.

6. Examination for Certified Public Accountant of Japan

The CPA examination is held by the Certified Public Accountant Investigation

Committee. This Committee has been set up as a subsidiary agency to the Ministry of Finance and aims at, beside conducting the CPA examination, investigation and consideration on important matters for the administration of the CPA system as well as disciplinary punishment to CPAs and Audit Corporations.

The CPA examination comprises First (preliminary), Second (intermediate) and Third (final) examinations. One who has passed the Second is given qualification to be Junior CPA, and the Third to be CPA.

The First examination exists to test scholarly attainment in liberal arts suitable to take the Second. Its subjects are as follows.

Japanese language: contemporary and classic language, grammar.

Mathematics: mathematics taught on the high school level (excluding calculus and differential).

Thesis: on general topics.

The Second examination aims to test specialty knowledges necessary to be Junior CPA, whose subjects are as follows.

Bookkeeping: commercial bookkeeping, industrial bookkeeping, banking bookkeeping.

Financial statements: accounting theory, corporate accounting principles, rules for financial statements, regulations concerning preparation of financial statements.

Cost accounting: actual cost accounting, standard cost accounting, special cost accounting, bookkeeping relative thereto.

Auditing: auditing system, auditing standards, auditing procedures, audit report.

Business administration: principles of business administration, personnel management, production management, sales management, financial management.

Economics: principles of economics, economic policies.

Commercial law: excluding those parts concerning maritime commerce, notes, drafts and checks.

As may be seen by the above list, the subjects of Second examination consist of major lessons given generally in the economics or business administration faculty of Japan's college, and so the examination is very attractive to college graduates. This is a reason why it is inviting many graduates of the highest seat of learning.

In order to pass this examination it is required that the aggregate score of the seven subjects of one examination attains to the level of success, not individual subjects. The successful candidate is admitted to the Japanese Institute of Certified Public Accountants as associated member, and is entitled Junior CPA after registering with the Institute.

Lastly the Third examination intends to examine whether one has high-degree professional ability of practical application necessary to be CPA, and

the candidate must have passed the Second examination and experienced three-year's apprenticeship—one-year's prescribed training and two-year's assistance in auditing and accounting practice. The subjects are—

Auditing practices relating to finance: auditing procedures, audit report;

Financial analysis;

Other accounting practices: bookkeeping, organization of accounting books, practices relating financial statements, practice about tax affairs;

Thesis.

While the First and Second examinations are only written tests, the Third is by both written and oral tests. And one is qualified to be a Certified Public Accountant only after passing it.

MAY 3, 1973