

## Oversight and Independence of CPA Auditing in Japan

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## **Amendment Project of the CPA Law**

The bill for amendment of the Certified Public Accountants Law (Law No.103, 1948) (the CPA Law) passed the Diet on May 30, 2003.

Amendment of the CPA law, which is the biggest change since the 1970s, has been called for in several years after the bubble economy crashed in the early 1990s and was finally concluded under strong influences of the U.S. Sarbanes-Oxley Act of 2002.

The following points are included in the amendment to the CPA Law:

### **1. Auditor independence rules**

#### **1-1 Non-audit services**

The prior CPA Law allowed CPAs to provide compiling financial statements, researching or planning financial matters, or responding to consultation on financial matters, to the extent that it did not impede the audit service.

The amended CPA Law, put into effect in April 2004, prohibits an Audit Corporation from providing certain non-audit services to any audit client in addition to tax services which had been prohibited by the prior law.

The list of non-audit services prohibited, which are provided in the supplemental cabinet ordinance, are as follows:

- 1 Services related to bookkeeping, financial documents, and accounting books,
- 2 Design of financial or accounting information systems,
- 3 Services related to appraisal of the contribution-in-kind reports,
- 4 Actuary services,
- 5 Internal audit outsourcing services,
- 6 Securities brokerage services,
- 7 Investment advisory services,
- 8 Other services that are equivalent to the above listed services, which may involve management decisions or lead to self-audit of the financial documents the auditor examines.

It is prohibited to provide these non-audit services to any clients that are required to be audited in accordance with the Securities and Exchange Law and certain large companies that are statutorily audited in accordance with the Commercial Code.

#### **1-2 Audit partner rotation**

Prior to the amendment, engagement partner rotation was required in the JICPA's Audit Standards Committee Statement as seven years term with two years time-out period. Under the amended CPA Law, all engagement partners are legally required to rotate every certain period within seven years with time-out period which are prescribed in a cabinet order. Partner rotation is also required with regard to statutory audit engagements that are based on the Securities and Exchange Law and the Commercial Code for the certain large companies. In this respect, the audit engagements to which the partner rotation rule is applied are the same as those for the prohibition of certain non-audit services.

#### **1-3 Cooling off**

The prior CPA Law had no clause that prohibits Audit Corporations from having an audited client that employs a retired partner of the Audit Corporation as management.

Under the amended CPA Law, an engagement partner who performs audit services to a client shall not be in the management of such a client as a director or some other important position until at least one year elapses after the end of the accounting period during which this partner was involved in auditing this client.

## **2. Strengthening auditor oversight**

Prior to the amendment FSA, as the regulator in Japan, oversaw auditors and JICPA to protect the public interest. FSA had a Board named the CPA Investigation and Examination Board, and this Board oversaw CPA examination and disciplinary action for CPAs.

The amended CPA Law also stipulates that a new CPA and Auditing Oversight Board (CPAAOB) be established by reorganization of the present CPA Investigation and Examination Board in order to enhance monitoring and oversight of CPAs and JICPA quality control review.

The CPAAOB consists of ten members who are to be nominated by the Prime Minister with consent by the Diet, and at least a chairperson and one member of the new Board serve full-time.

Also, the amendment introduces the legal authority for JICPA to conduct quality control reviews. The quality control review is currently a legally required measure.

## **3. Reform of CPA Examination**

The amendment of the CPA Law contains the reform of the CPA examination system and this amendment regarding the CPA examination will be effective as of January 2006. The new CPA examination will be simplified to a single step examination (currently three steps).

All candidates who have passed CPA examination are required to take two years practice training, which can be taken before sitting for the examination, one year schooling and the final assessment to be provided by JICPA in order to be acknowledged as CPAs.

## **4. Introduction of limited liabilities of partners**

Prior to the amendment, every partner of an Audit Corporation was jointly and un-limitedly liable for liabilities. Under the amended CPA Law, a new concept named 'designated partner' was created to alleviate burdens of partners who are not designated as engagement partners. Only the partners who perform audits (designated partner) are jointly and severally liable for misconduct and negligence, and other partners who are not involved in the audits in question are liable to their equities, at maximum, in the audit corporation with regard to the liabilities claimed by audit clients.

However, this designated partner system is different from limited liability partnership. Non-engagement partners are still liable for third party claims. In this respect, non-engagement partners are jointly and severally liable for third party claims together with the engagement partner(s).

## **1. Structure of the CPA Profession in Japan**

### **1-1 Introduction**

Historically, the audit profession in Japan developed under strong government leadership over the last fifty years in order to promote sound development of the Japanese capital market.

The first group of professional accountants in Japan is said to have emerged around 1907, but it was not until 1927, when the Accountants Law was enacted, that a fledgling institute of professional accountants came into existence. However, the formal institutionalization of the profession had to wait for the enactment of the CPA Law (as amended) in July 1948, following the enactment of the Securities and Exchange Law( Law No. 25, 1948 ) in April 1948. The CPA Law was designed to ensure the quality of professionals compared with those in the U.S. mainly, and to establish socially recognized status for CPAs. The Japanese Institute of Certified Public Accountants (JICPA) started in 1949.

Many such measures were introduced under the supervision of the General Headquarters (GHQ) during the Allied Forces occupation period after World War II. These measures helped to respond to the growing post-war demand for the democratization of business, the disclosure of corporate information following the dissolution of *zaibatsu* (conglomerate), and the introduction of foreign capital. Since that time, the audit profession in Japan has been highly regulated by the regulatory authorities.

### **1-2 The CPA Law**

The CPA Law provides the basic structure of the audit profession in Japan. It includes the scope of services to be provided by CPAs, mechanisms of the national CPA examination, requisitions of the CPA qualification, establishment of audit firms (Audit Corporation: *kansa hojin*), duties and responsibilities of CPAs, roles and organization of JICPA, roles of regulatory authority and the disciplinary and criminal sanctions against CPAs. The Financial Services Agency (FSA) is given authoritative power to oversee CPAs, Audit Corporations and JICPA by the CPA Law.

### **1-3 Financial Services Agency (FSA)**

The FSA has oversight responsibilities over the accounting profession in Japan. The CPA examination is conducted by the CPA and Auditing Oversight Board (CPA AOB) established in FSA (Article 15 of the CPA Law). Recent amendments to CPA Law changed the legal procedures for incorporation, dissolution, mergers and the amendment to the articles of incorporation of an Audit Corporation from approval basis to filing basis to FSA (Article 34-9-2, 34-10, 34-18 and 34-19). Audit Corporations and CPAs are subject to FSA's requirements of reporting and submission of the necessary materials (Article 49-3) and are subject to disciplinary sanctions including suspension of practice or revocation of qualification registrations (Articles 29 through 31, and 34-21). Audit Corporations and CPAs are subject to examinations and inspections by FSA (Articles 32,

33 and 34-21). FSA also oversees JICPA, the description of which follows.

#### **1-4 The Japanese Institute of Certified Public Accountants (JICPA)**

The establishment of JICPA is compulsory under the CPA Law (Article 43, (1) of the CPA Law). JICPA is the only professional accounting body in Japan. It was originally formed in 1949 as a voluntary body, and was reorganized in 1966 into its present form requiring every CPA in practice to become a member of the Institute.

The most important role of JICPA is to keep a register of CPAs. All qualified CPAs should be registered under his or her own name and address in the Register of the Institute (Articles 17 and 18). Inclusion in the register denotes qualification as a CPA in Japan. JICPA can revoke registration of members who are disciplinary sanctioned as such. In this regard, JICPA may perform the role of the State Accountancy Board in the USA. The Institute's other roles under the CPA Law are to effectively exercise guidance to, communicate with, and supervise the members in order to uphold professional standards and to improve and advance the profession (Article 43, (2)). Members are legally required to comply with the JICPA Constitution (Article 46-3). The Constitution includes provisions on members' obligations to observe the Code of Ethics and other resolutions of various committees including the Audit Standards, the Quality Control Review, the Audit Practice and the Review Committees. Changes in the JICPA Constitution must be approved by FSA (Article 44, (2)). Pursuant to the JICPA Constitution, members are subject to reporting requirements, direction and disciplinary action by JICPA (Article 46-3). In addition, CPAs and Audit Corporations who perform audits for publicly held corporations should be reviewed periodically by the Quality Control Reviewers from JICPA (Article 87, (3) of the JICPA Constitution).

## **2. Public Practice of CPAs and Audit Corporations**

### **2-1 Qualifications (The CPA Examination System in Japan)**

Instituted in 1948 upon the promulgation of the CPA Law, the CPA examination is considered one of the most difficult examinations conducted by the Japanese Government. The examination has been adopted in order to assure that those who have adequate professional ability and practical experience, together with a high level of professional ethics, perform audits. Some amendments have been made according to the demands of the changing times with the aim of improving the quality of Japanese CPAs. All examinations are prepared by knowledgeable experts, such as experienced CPAs and university professors under the oversight of the CPA Investigation and Examination Board established in FSA (Articles 15, 35 and 38 of the CPA Law).

The subjects included in the first examination are Japanese, English, Mathematics, and an Essay. Its aim is to measure a candidate's general literacy (Article 6). University graduates and their equivalents are exempt from the first examination. The subjects of the second examination are Accounting Theory, Accounting Practice (bookkeeping), Cost Accounting, Auditing Theory, the Commercial Code (Law No.48, 1899), Economics, Business Administration, and the Civil Code (candidates select two from among the last three subjects). The second examination aims to measure whether a candidate holds a university graduate's level of competency (Article 8). Successful candidates of the second examination are qualified as junior CPAs. Before taking the third examination, junior CPAs are required to go through the minimum of three years of professional training, including two years of internship, and one year of schooling (Article 11). The third examination measures the level of professional competency in the subjects of Auditing Practices, Financial Analysis Practices, Taxation Practices and an Essay (Article 10). After passing the third examination, candidates are given the title CPA. The following chart shows the number of candidates and the number of successful candidates from among them.

The amendment of the CPA Law reforms the CPA examination system and this amendment regarding the CPA examination will be effective as of January 2006. The new CPA examination will be simplified to a single examination. People who satisfy certain requirements, successful candidates of certain other professional examinations and people who are qualified professionals are exempt from taking certain subjects in the CPA examination.

However, all candidates who have passed CPA examination are required to take two years practice training, which can be taken before sitting for the examination, one year schooling and the final assessment to be provided by JICPA in order to be awarded a CPA qualification.

### Historical Trends of Candidates/Successful Candidates of the CPA Examination

	First Level			Second Level			Third Level		
	Apply	Pass	%	Apply	Pass	%	Apply	Pass	%
2002	150	30	20.0	13,389	1,148	8.6	n.a	n.a	n.a
2001	119	19	16.0	12,073	961	8.0	1,154	710	61.5
2000	141	28	19.9	11,058	838	7.6	1,143	679	59.4
1999	221	34	15.4	10,265	786	7.7	1,154	654	56.7
1998	227	27	11.9	10,006	672	6.7	1,150	651	56.6
Cumulative Total since inception	29,040	4,435	15.3	274,970	20,482	7.4	48,203	15,124	31.4

### 2-2 Audit Corporations and CPAs

As of March 31, 2002, there were 13,721 CPAs, 4,301 junior CPAs and 147 Audit Corporations in Japan. An Audit Corporation is a corporation that consists of only CPAs who are all unlimited liability contributors and are also expected to participate in management (Article 34-4). These CPAs are not legally regarded as partners since Japanese law does not provide for this form of partnership common in the United States and Europe for professional services (but “partner” is used hereafter for the readers of this paper). An Audit Corporation is a legal entity performing an audit. The Audit Corporation system was introduced by the CPA Law amendment of 1966 in order to take advantage of a larger business base that would justify the establishment of large professional firms to have organized audit services and acceptable competence of CPAs that can be comparable to world best practices. It was hoped that Audit Corporations would assist CPAs in better maintaining their independence and integrity as professionals and increase the public trust in the profession.

Prior to the amendment, every partner of an audit corporation is jointly and un-limitedly liable for liabilities. Under the amended CPA Law, a new concept named ‘designated partner’ was created to alleviate burdens of partners who are not engagement partners. The only partners who perform audits (designated partner) are jointly and severally liable for misconduct and negligence, and other partners who are not involved in the audits in question are liable, at maximum, to their equities in the audit corporation with regard to the liabilities claimed by audit clients.

However, this designated partner system is different from limited liability partnership. Non-engagement partners are still liable for third party claims. That is, if their equities in the audit corporation are not enough to pay off all the third party claims, they have to pay for the third party claims with their personal properties. In this respect, non-engagement partners are jointly and severally liable for third party claims together with the engagement partner.

One of the future agenda for the CPA profession is the introduction of limited liability system which is not permitted in Japan. Therefore, limited liability partnership system for the audit

corporation shall continue to be considered in the future amendment of the CPA Law.

147 Audit Corporations account for 50.5% of CPAs and 60.7% of junior CPAs. Even though there are many Audit Corporations, most of them are very small while four Audit Corporations are very large as shown below.

Number of CPAs at the four large Audit Corporations

Audit Corp.	Number of CPAs
A	1,361
B	1,255
C	1,242
D	1,126
Total	4,984

There are almost 4,500 companies subject to the statutory audits required by the Securities and Exchange Law of Japan (both listed and non-listed) . The largest four Audit Corporations in Japan provide audit services to almost 3,400 companies in accordance with the Securities and Exchange Law, accounting for 76.4% of all companies.

The breakdown of auditors for companies subject to statutory audits based on the Securities and Exchange Law are as follows:

	No. of audit clients	Share
Large four Audit Corp.	3,397	76.4%
Small Audit Corp.	744	16.7
Sole practitioners	305	6.9
Total	4,446	100%

The practice of the Audit Corporation is limited to audits and other services including 1) compilation of financial statements, research, advice and consulting services relating to financial matters for clients and 2) schooling of junior CPAs; as long as such work does not impede the audit service (Article 34-5). Any Audit Corporation is not permitted to provide tax services; however, an individual CPA is permitted to provide tax services (Article 3 of the Licensed Tax Accountant Law).



Accordingly, all large Audit Corporations concentrate on providing audit services. Consulting and tax services are provided by legally separated entities of each group. The revenue of consulting and tax services is relatively small compared with similar groups in the U.S. and other countries. The following table shows the fee split of these groups.

Fee split of the four large Audit Corporation groups (in billions of yen)

Audit Corp. Groups	A		B		C		D	
	Revenue	%	Revenue	%	Revenue	%	Revenue	%
Audit Corporation	¥ 48.1	72.6	¥ 42.5	82.3	¥ 40.5	55.3	¥ 36.8	64.5
Consulting entity	9.2	13.9	1.4	2.8	28.6	39.0	14.9	26.1
Tax entity	9.0	13.5	7.7	14.9	4.1	5.7	5.3	9.4
Total	¥ 66.3	100.0	¥ 51.6	100.0	¥ 73.2	100.0	¥ 57.0	100.0

(Source: Nihon Keizai Shimbun, August 21, 2002)

### 2-3 Professional Competency

The Japanese CPA examination does not require a candidate to have a university degree in accounting or management. However, the second CPA examination tests whether a candidate has a thorough knowledge (equivalent to an undergraduate level) of accounting, auditing and related business subjects and the third examination tests professional knowledge obtained through three years of professional training. In this sense, de facto pre-qualification education is required for Japanese CPAs.

The mechanism for the maintenance of post-qualified professional competency is provided by Continuing Professional Education (CPE). CPE has been mandatory since April 2002 for CPAs, who are full members of JICPA (Article 83, (2) of the JICPA Constitution). Junior CPAs are not required to satisfy CPE requirements because the majority of junior CPAs are enrolled in the three-year practice training courses. Furthermore, junior CPAs have to take the third examination in order to be qualified as CPAs.

In April 1997, the CPE program was recommended by the CPA Investigation and Examination Board under, "Recommendations to Strengthen CPA Audits." In April 1998, CPE was first introduced to JICPA members as a voluntary program that each member was recommended to follow. JICPA sets forty hours of training as an annual target for CPE.

JICPA classifies CPE training as self-study and seminar. Self-study is a broad category that includes not only reading but also watching videos, listening to audio tapes, taking distance educational programs, and attending small study-group meetings. A member can earn required credits by applying one or more self-study methods. For example, a

member can earn certain credits by reading books and articles. Up to forty credits a year can be earned by self-study of reading the articles in the JICPA Journals and Newsletters, both of which are JICPA monthly publications. When a member reports which articles he/she has read, he/she has to write a short essay on each article.

Now that CPE is mandatory effective April 2002, members have even more incentive to take seminars. They can earn credits by attending seminars organized by various institutions: JICPA, Audit Corporations, the Bar Association or the Licensed Tax Accountants Association.

JICPA holds topical subject seminars frequently throughout the year. In addition, it holds three- or four- day intensive seminars five times a year. More than 4,000 people attended winter seminars held in thirteen cities throughout Japan between January 24 and 26, 2001. More than 5,400 people attended summer seminars held in Tokyo and Osaka between August 23 and 31, 2001. JICPA held the following four-day seminars in early December 2002. A member can choose from any topic to attend.

The following is a sample of the four-day seminars JICPA held in early December 2002:

Date	Credits	Topics
12/3/02	2	Newly created company-reorganization-law: basics
12/3/02	2	Case studies of CPA ethical code violations
12/3/02	2	Comparative studies of US GAAP, Japanese GAAP and International Accounting Standards
12/4/02	2	The Information Technology Committee statement No. 1 entitled, "Evaluation of control risks in information technology in the financial statement audits"
12/4/02	2	Capital transfer tax: case studies
12/4/02	2	Taxes on sales of properties and securities: case studies
12/5/02	2	New consulting area: actuaries
12/5/02	2	Business plans to raise funds for venture businesses
12/5/02	2	Corporate income taxes: case studies
12/6/02	6	External auditors for local governments
12/6/02	6	Accounting for retirement-benefit plans

When members fail to submit CPE reports, JICPA follows up by sending them a reminder. CPE results are maintained in JICPA website to which members can access. JICPA members are required to earn forty credits a year. If he or she does not earn forty credits in a year, he or she has to earn extra credits in the following year(s). If a member did not earn forty credits for a year without any reasonable excuse, he or she will be sanctioned. CPE credit completion for audit team members of Audit Corporations is an important review subject for the Quality Control Review.

### **3. Standard Setting**

#### **3-1 Audit Standard Setting in the Business Accounting Council**

In Japan, audit standards are developed by FSA's Business Accounting Council (BAC) and JICPA's Auditing Standards Committee. The BAC Audit Standards Sub-Group consists of nineteen members who are drawn from universities, businesses and Audit Corporations, and develops core audit standards through a consensus among stakeholders. Core audit standards underline basic concepts for audits of financial statements.

In January 2002, BAC issued new auditing standards. This issue was prompted by both the need to harmonize with the present international state on auditing standards including the International Standards on Auditing (ISA) and the changes in the Japanese corporate and audit environment. In these new standards, the following basic concepts have been introduced in audit practices:

- a) Audit objectives emphasizing that auditors obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement.
- b) Recognizing that company management is responsible for preparing financial statements, while the auditors are responsible for forming and expressing opinions on the financial statements. The responsibility for preparing and presenting the financial statements lies with the management, and an audit of the financial statements does not relieve management of their responsibilities.
- c) Company management is required to disclose serious going concern issues that may jeopardize the viability of the company in financial statements. Auditors are required to audit the appropriateness of such disclosures and are obligated to refer to such going concern issues in the audit report to provide information to the public. In addition, auditors must state adverse opinions when they have determined that it is not appropriate for the company to prepare its financial statements based on the going concern assumption.
- d) In the new auditing standards, JICPA is clearly recognized as the auditing-guideline setter. The preface to the new auditing standards states that the auditing standards together with the guidelines issued by JICPA form generally accepted auditing standards (GAAS) in Japan.

#### **3-2 JICPA's Audit Standards Committee**

In the last ten years, BAC and JICPA have been sharing in the process of standard setting. Thus, the JICPA Auditing Standards Committee has issued more than 20 statements, which are largely modeled after ISA. In addition to the Auditing Standards Committee, the Auditing Committee, currently renamed Auditing and Assurance Practice Committee has issued various statements and guidelines regarding practical issues that have emerged during audits. JICPA members should follow these committee statements and guidelines (Article 20 of the JICPA Constitution). These statements and guidelines issued by the Auditing Standards Committee and Auditing Committee are integral part of GAAS in Japan.

There are thirty-four members on the Auditing Standards Committee (all of them are JICPA members). The Committee organizes a plenary session and several steering committees that prepare statements based on consultation with the JICPA Council. The JICPA Council issues the final approval on statements. There is also an advisory forum: the Audit Issues Discussion Forum, which consists of members from academics, users, preparers (public companies) and CPAs in order to gather views and opinions outside CPA profession. Major proposed drafts of the standards are exposed to the public for comments. Between August 2001 and July 2002, twenty-four plenary sessions and eighty-one steering committee meetings were held.

The Auditing Committee includes ninety-six members (all of them are JICPA members) who meet in plenary sessions, chair & vice-chair sessions and steering committees, which are established for each project (currently nine steering committees exist). Certain drafts are exposed to the public for comments. Between April 2001 and March 2002, four plenary sessions, ten chair & vice-chair sessions and forty-five steering committee meetings were held.

### **3-3 The Code of Ethics**

JICPA develops the Code of Ethics for its members. In 2000, JICPA's annual assembly approved a revision of the Code of Ethics that was proposed by the Enhancement of Professional Ethics Project Team in JICPA. The new Code of Ethics is harmonized with the, "Code of Ethics for Professional Accountants" (revised in 1998) of the International Federation of Accountants (IFAC). Further development of the Ethics Code is under way in the newly established Independence Study ad-hoc Committee, in order to reflect IFAC's new principle-based independence rules, which were announced in 2001.

The Code of Ethics prescribes that "Certified Public Accountants have a duty to perform their work with professional competence, integrity and objectivity to benefit the public interest and to contribute to the development of a sound society as professionals in auditing and accounting," and requires CPAs to have integrity, objectivity, professional competency, due care, confidentiality and professional behavior.

## **4. Independence Requirements for CPAs**

Independence requirements for external auditors exist in laws and the Code of Ethics.

### **4-1 CPA Law**

#### **4-1-1 Individual CPAs**

In accordance with Article 24 of the CPA Law, a CPA shall not render audit services in the following cases:

- (a) The financial statements of those corporations or any other organizations in which he/she or his/her spouse is, or was, within the past year an officer or staff member corresponding thereto or a responsible official in charge of affairs concerning financial matters.
- (b) The financial statements of those corporations or any other organizations for which he/she is, or was an employee within the past year.
- (c) In addition to those coming under the preceding items, the financial statements of those corporations or any other organizations which he/she has substantial interests.

"Substantial interests" prescribed in item (c) above of the preceding paragraph shall include business, financial or other relationship between a CPA or his/her spouse and the corporations or any other organizations (clients) in order to maintain fairness in an audit by a CPA described as follows:

- i) A CPA or his/her spouse was a director and/or an officer of the client during the audit period.
- ii) A CPA's spouse is or was an employee of the client during the past one year.
- iii) A CPA's spouse is or was a government official that had a close relationship with the client during the past two years.
- iv) A CPA or his/her spouse owns stock of the client and/or debt or credit.
- v) A CPA or his/her spouse has special economic interests such as office rent or borrowing money with free or unreasonably low rent or interest.
- vi) A CPA or his/her spouse provides tax services for the audit client.
- vii) A CPA or his/her spouse is provided special economic interests described above in v) by any director of the audit client, or provides tax services for any director of the audit client.
- viii) A CPA or his/her spouse is a director of an affiliated company of the audit client.
- ix) A CPA or his/her spouse is an employee of the parent company or subsidiary of the audit client.

A CPA who was once a national or local government official shall not conduct, during his tenure of office or during the two years following his termination, an audit practice with respect to the financial affairs of those business enterprises closely related to the duties of the office held during the two years preceding his retirement.

#### **4-1-2 Audit Corporations**

Also in accordance with Article 34-11 of the CPA Law, an Audit Corporation shall not conduct audit practices relating to those financial statements falling under one of the

following items:

- (a) Financial statements of the companies or entities whose stock the Audit Corporation owns or in which the Audit Corporation is investing.
- (b) In addition to those stipulated in the preceding item, financial statements of companies or others in which the Audit Corporation has substantial interests.

“Substantial interests” in item (b) above of the preceding paragraph shall include such businesses, finances, and so on between the Audit Corporation or its partners and the company or others as described below:

- i) An Audit Corporation is either a debtor or creditor of the audit client in any amount.
- ii) An Audit Corporation has special economic interests such as office rent or borrowing money with free or unreasonably low rent or interest.
- iii) An Audit Corporation is provided special economic interests described in the above from a director of the audit client.
- iv) Any partner of an Audit Corporation is a director, a corporate statutory auditor and/or an employee of the audit client and/or the parent company or subsidiary of it.
- v) Any partner of an Audit Corporation provides tax services for the audit client.
- vi) The majority of partners of an Audit Corporation have any kind of relationship as described in Article 24 of the CPA Law (relationship of individual CPAs as referred to above).

Further, any partner of an Audit Corporation who has a relationship as described in Paragraphs (1) to (3) of Article 24, with the company or others shall not be engaged in an audit practice concerning the financial statements of such companies or entities conducted by the Audit Corporation.

Audit Corporations are permitted to provide financial advisory and consulting services for any clients as long as such services do not impede the audit service (Article 34-5), but they are prohibited from providing tax services. On the other hand, individual CPAs are permitted to provide tax services excluding the ones for audit clients (Article 3 of the Licensed Tax Accountant Law).

#### **4-2 JICPA's Code of Ethics**

Article 14 of the Code of Ethics requires independence of auditors as follows:

- (1) When undertaking or performing an audit, CPAs shall not accept any position prohibited by law or ordinance, or to hold any financial interest in clients or concerned parties, and shall take care to avoid relationships or appearances which may impair their independence.
- (2) The positions and relationships described in the preceding paragraph shall include situations applicable to any of the following:
  - i) A CPA who is engaged with audit for an entity as a support staff has such relationships as detailed in the CPA Law.

- ii) Any relatives within the second degree of a CPA who is engaged with audit for an entity, as a sole practitioner or as a engagement partner of an audit corporation, has such relationships as detailed in Article 24 of the CPA Law.

Appearances that may impair a CPA's independence are described in the Interpretation Guidance for Article 14 of the Code as follows:

- (1) Audit fee received from a certain client or its group exceeds fifty percent of total revenue of a CPA or an Audit Corporation.
- (2) A partner or partners have been engaged with an audit client for a long (more than seven year) period.
- (3) A lawsuit exists or will exist with an audit client.
- (4) Unreasonably expensive gifts are provided by an audit client.
- (5) A CPA was once an officer of an audit client.
- (6) A CPA or an Audit Corporation owns an audit client's stock.

Another Interpretation Guidance of the Code also prevents a CPA or Audit Corporation from executing or consummating management authority or responsibility when non-audit services are provided for an audit client.

Further development of the Ethics Code is under way in the newly established Independence Study ad-hoc Committee in order to reflect IFAC's new principle-based independence rules and recent U.S. developments.

#### **4-3 Securities and Exchange Law and Commercial Code**

Similar independence requirements are provided in these laws as follows:

- (a) All provisions required in Article 24 (for individual CPAs) and 34-11 (for Audit Corporations) of the CPA Law are applicable to CPAs and Audit Corporations performing the audit required by the Securities and Exchange Law. In fact, independence rules are stricter in the Securities and Exchange Law than in the CPA Law, and auditors are required to comply with these more rigorous rules for the Securities and Exchange Law audits. For example, the coverage of related persons described as "CPA and his/her spouse" is widened to "CPA, his/her spouse and relatives within the second degree." Economic relationships with the client "company" are widened to the client "company and any of its affiliates included in the consolidated financial statements" (Article 2 of the Cabinet Ordinance relating to the audit of financial statements).
- (b) All CPA Law provisions are applicable to CPAs and Audit Corporations performing Commercial Code audits (Article 4 of the Law Concerning Special Measures under the Commercial Code with respect to the Audit of Corporations).

#### **4-4 Audit Partner Rotations**

The JICPA Auditing Standards Committee Statements No. 12 "Quality Control for Audit" recommends that each Audit Corporation rotate engagement partners for particular audit engagements of listed companies at least every seven years with time-out periods of two

years.

In the amended of the CPA Law, put into effect in April 2004, all engagement partner are legally required to rotate every certain period within seven years with time-out periods which will be prescribed in a cabinet order.

Partner rotation is required for the Securities and Exchange Law audits and certain large company audits pursuant to the Commercial Code. The amendment will be effective as of April 2004.

#### **4-5 Prohibition of Tax Practice**

As previously described, no Audit Corporation is permitted to provide tax services (Article 3 of the Tax Accountant Law).

#### **4-6 Scope of Audit Corporation Services**

As previously mentioned, the scope of Audit Corporation services is limited to audits and audit-related services: including compilation of financial statements, research, advice and consultation on financial matters as long as such services do not impede conducting the audit service (Article 34-5 of the CPA Law). This requirement virtually prevents Audit Corporations from providing extensive consulting services to their audit clients.

The amended CPA Law, put into effect in April 2004 restricts audit firms in providing certain non-audit services to audit clients. Prohibition of the following non-audit services is provided in the supplemental cabinet order:

- 1 Services related to bookkeeping, financial documents, accounting books,
- 2 Design of financial or accounting information systems,
- 3 Services related to appraisal of the contribution-in-kind reports,
- 4 Actuary services,
- 5 Internal audit outsourcing services,
- 6 Securities brokerage services,
- 7 Investment advisory services,
- 8 Other services that are equivalent to the above listed services, which may involve management decisions or lead to self-audit of the financial documents the auditor examines.

These non-audit services are prohibited to any clients that are required to be audited in accordance with Securities and Exchange Law and certain large companies that are required audits by Commercial Code.

#### **4-7 Cooling off**

Previously, there were no rules regarding whether an engagement partner is permitted to accept a management position in the audit client.

In the amended CPA Law, put into effect in April 2004 an engagement partner who performs audit services to a client shall not be in the management of such a client as a director or some other important position until at least one year elapses after the end of the accounting period during which this partner was involved in auditing this client.



## **5. Oversight of Statutory Audits in Japan**

### **5-1 FSA**

#### **5-1-1 Regulator Function of Statutory Audits by FSA**

FSA is responsible for ensuring the stability of the financial system in Japan, and the protection of depositors, insurance policy holders, and securities investors by inspecting financial institutions and conducting surveillance of securities transactions.

Pursuant to these responsibilities, FSA inspects and supervises banks, securities companies, insurance companies, and other financial institutions, and FSA also performs activities related to corporate disclosure and securities markets such as: supervision of CPAs and Audit Corporations, surveillance of rules governing securities markets, and the establishment of rules for trading in securities markets.

The Office of the Director for Corporate Accounting and Disclosure in FSA Planning and Coordination Bureau monitors both auditing activities of Audit Corporations and CPAs, and reviews financial statements of certain publicly owned companies that are filed pursuant to the Securities and Exchange Law.

#### **(1) Monitoring of Audit Activities**

##### **1) Approval of establishment of Audit Corporations**

FSA has various oversight responsibilities over the accounting profession in Japan.

For example, Audit Corporations cannot be legally established unless they obtain FSA's approval (Articles 34-7 and 34-8 of the CPA Law). When an Audit Corporation plans a merger with another Audit Corporation, they are required to obtain FSA's approval (Articles 34-18, (2) and 34-19, (2) of the CPA Law).

However, the recent amendment to the CPA law changes FSA's authority to approve or disapprove the establishment of Audit Corporations to much simpler filing of the Audit Corporations with FSA. In this amendment, the procedures for establishing, dissolving an audit corporation, merging an audit corporation with some other audit corporation, and modifying the articles of incorporation of Audit Corporation changed from requiring FSA's approval to simply filing with FSA.

##### **2) Review of Audit Corporations' annual report and the summary of individual audit engagements**

Every year FSA reviews the Audit Corporations' annual business reports including financial statements. Audit Corporations are required to file these documents with FSA (Article 34-16 of the CPA Law).

FSA also reviews the summary reports of individual audit engagements, described below, prepared by CPAs or Audit Corporations. CPAs and Audit Corporations are required to file with FSA the summary report of all individual audit engagements for audits required under the Securities and Exchange Law. CPAs and Audit Corporations are also required to file with JICPA a copy of the above summary and other similar summaries for audits required under the Commercial Code. These summaries may serve as a basic measure to evaluate whether adequate engagement hours were spent, and determine whether key audit procedures were conducted. They are not disclosed to the public.

The summary to be submitted to FSA is required to include the following descriptions:

- a) The qualifications (namely “lead auditor or engagement partner,” “CPA,” “junior CPA,” and “other audit staff”) and names of audit staff.
- b) Any changes in the lead engagement partner, Audit Corporation, or responsible CPA in case of a sole practitioner engagement.
- c) Total engagement hours spent on the audit work (separately described according to the auditors’ qualifications).
- d) Audit and assurance fee amount and other services fee amount for the year and previous year, respectively.
- e) Information on quality control; the name or the section of the Audit Corporation, who is responsible for quality control and the name of concurring reviewers.
- f) Matters particularly considered in the course of audit work as follows:
  - Communication with predecessor auditors
  - Significant matters particularly considered in audit planning and audit procedures
  - Reports to management concerning material weakness in internal control
  - Response to significant fraud and illegal acts
  - Discussion with management
- g) Information of reliance on other auditors’ audit results, if any.
- h) Additional explanations of an auditor's opinions when unqualified opinions are not expressed.
- i) Information on the independent review.
- j) Information on explanatory paragraphs.

Furthermore, if FSA finds it necessary to obtain additional reports from Audit Corporations and/or CPAs, it is entitled to collect such reports (Article 49-3 of the CPA Law).

### 3) Enhancement of FSA oversight function

The amended CPA Law enhances FSA authority by introducing the general authority of on-site inspections of Audit Corporations, while previously FSA’s on-site inspections were conducted for the purpose of taking disciplinary actions. In this amendment, FSA also introduced the authority of administrative direction against Audit Corporations, while previously FSA was not empowered to take administrative directions and simply authorized to take such disciplinary actions as business suspension orders and revocation of approvals of establishment. Furthermore, the amendment newly grants FSA to have business improvement order against JICPA while previously FSA did not have such power.

### **(2) Review of financial statements of certain companies**

All Japanese publicly owned companies file their annual securities reports including financial statements audited by CPAs or Audit Corporations with FSA (actually local finance bureaus of the Ministry of Finance (MOF)) within three months after the close of the fiscal year (Article 24 of the Securities and Exchange Law). There are eleven regional finance bureaus that are spread all over Japan. The Kanto Local Finance Bureau

received and reviewed 3,111 securities reports, accounting for approximately 68% of the total 4,575 securities reports received by all local bureaus in fiscal 2003.

### **5-1-2 CPA Investigation and Examination Board**

The CPA Investigation and Examination Board has two responsibilities:

- (1) administer the CPA examination by establishing items necessary for the administration of the examination;
- (2) consider the disciplinary actions against CPAs or Audit Corporations that have committed audit failures, and advise to FSA whether the proposed disciplinary actions are adequate.

The CPA Investigation and Examination Board consists of nine distinguished people: three executives from listed companies, three academics, the former Japanese Governmental Accounting Office Chief, a representative from the Japanese Securities Dealers Association, and the JICPA President.

Each resolution will be decided by majority rule at the CPA Investigation and Examination Board. The meetings are held several times a year.

The amended CPA Law stipulates the establishment of a new CPA and Auditing Oversight Board (CPAAOB) to monitor and oversee CPAs and the JICPA quality control review. The CPAAOB has ten members who are to be nominated by the Prime Minister with consent by the Diet and at least a chairperson and one member of the new Board will serve full-time. The new Board replaces the current CPA Investigation and Examination Board which oversees CPA examination and disciplinary action for CPAs.

### **5-2 JICPA**

As previously described, FSA is given authoritative power to oversee JICPA by the CPA Law. JICPA has two different oversight systems. First, the Quality Control Review oversees quality control of members' audit engagements. Second, the Audit Practice and Review Committee oversees individual audit engagements.

#### **5-2-1 Quality Control Review**

##### **(1) Introduction**

During the 1990's economic recession, the Japanese accounting and auditing system was under scrutiny, and improvement of the system was considered necessary. Faced with increasing public attention over external auditing, JICPA introduced a post-audit review system. In March 1997, JICPA established a project team for Quality Control. In April 1997, the CPA Investigation and Examination Board, then an advisory body to the Finance Minister, recommended a post-audit review system. Meanwhile, JICPA's Auditing Standards Committee issued the Auditing Standards Committee Statement No.12 "Quality Control of Audits" that requires all Audit Corporations and CPAs to perform quality control of audit practices. In March 1998, the Quality Control Project Team issued an important statement regarding the implementation of quality control reviews in Japan proposing that JICPA's full-time professionals conduct

quality-assurance monitoring reviews of all Audit Corporations and CPAs who are engaged in the listed company audits. All such Audit Corporations and CPAs shall be reviewed once in every three years to assess whether they conduct audit practices in compliance with the Auditing Standards Committee Statement No.12, which is modeled after the International Standards on Auditing 220 and other related requirements. Considering practicability, especially in smaller firms, JICPA did not employ the firm-on-firm peer review system. At the JICPA General Assembly in July 1998, its members approved a proposal to require quality control reviews. The quality control review teams began conducting their reviews in April 1999.

In the amended CPA Law, a clause has been newly created to provide JICPA with the legal authority to conduct quality control review.

The JICPA quality control review is performed for audit practices only, not management-consulting services. In March 2001, there were 308 auditors (including sole practitioners and Audit Corporations) that were subject to the quality control review from among the audits of 3,843 listed companies.

## **(2) Review Organization and Procedures**

In order to implement the quality control review system, JICPA created a Quality Control Review Committee consisting of predominantly JICPA council members and other well-experienced members that plans quality control reviews and directs the Quality Control Review Team that executes reviews. The Quality Control Review Team is independent of other JICPA organizations and reports directly to the Quality Control Review Committee. The team consists of full-time reviewers including one chief reviewer and five- qualified reviewers. Each reviewer must be independent of the reviewed firm and is required to have enough current and additional knowledge on audit practices. Also, the reviewers are required to preserve the confidentiality of information that they may find during the course of review.

The reviewers must establish a reasonable basis for expressing an opinion on whether the firm's system of audit quality controls, both firm-wide and on an individual engagement basis, has been well designed in accordance with the JICPA Quality Control Standards, and that such quality control policies and procedures have been adequately implemented. The review does not determine whether auditors' conclusions are appropriate, rather it reviews the audit process conducted by the auditors.

The review procedures include interviews with professional personnel at various levels and the review of relevant audit working papers. In accordance with the JICPA's Auditing Standards Committee Statement No. 12 and other standards, reviewers are to examine whether audit firms (including both Audit Corporations and sole practitioners) properly adopt the professional requirements of independence, integrity, confidentiality and professional behavior. Also, reviewers examine (a) whether necessary skills and competence are attained and maintained through CPE, (b) a proper assignment policy such as the JICPA's seven-year partner rotation rule is adopted, (c) audit engagement is

independently reviewed by an independent concurring partner, (d) acceptance and retention of clients are properly controlled and (e) monitoring is adequately provided. Based on the review, a written report is addressed to the firm's chief executive partner. If reviewers find that anything needs to be improved or the reviewed firm has not conformed to the quality control policies and procedures, the findings and recommendations are to be reported to the firm. The firm must respond in writing in due course. Sometimes it takes some months for an audit firm to determine the corrective measures.

The review team usually spends an average of two-three man-days for a sole practitioner office and five-six man-days for a small audit firm while it spends over a hundred man-days for a large audit firm as shown in the following table.

Average number of man-days for quality control review by the number of auditors for a two- year period (April 1999 to March 2001):

	No. of firms or offices	Man-days	Average man-days
Large audit firms	6	645	107.5
Small audit firms	109	639	5.9
Sole practitioner offices	215	502	2.3
Total	330	1,786	

The total JICPA cost of these reviews is almost ¥100 million per year. It mainly consists of salaries for reviewers and travel expenses. In order to cover these costs, fees are collected from all JICPA members who are engaged in audits of publicly held companies based on (approximately 0.1 percent of) their audit engagement fee.

### **(3) Review results**

In fiscal year 2001 (between April 2001 and March 2002), the Quality Control Review Teams reviewed 107 audit firms, including eleven audit firms whose review began in fiscal 2000. The Review Teams issued the review reports of 104 audit firms and also issued letters of recommendations to ninety-nine audit firms. The Review Teams will issue the review reports to the five remaining audit firms in fiscal 2002 because the review reports were not completed as of March 31, 2002. In the six months between April and September 2002, the Quality Control Review Teams issued review reports to three audit firms. However, they have not issued review reports to the remaining two audit firms. These two cases are related to sole practitioners, and it took some time for these practitioners to reply to the inquiries or recommendations proposed by the Quality Control Review Teams.

In the first six months of fiscal 2002 (between April 2002 and September 2002), the Quality Control Review Teams completed their fieldwork for thirty-seven audit firms, and issued review reports to eleven audit firms. However, they have not issued review reports for twenty-six audit firms yet because they have not received the audit firms' preliminary

responses to their draft recommendations, or they are still preparing the letters of recommendations, or the review committee's internal review has not been completed.

#### **(4) Quality Control Oversight Board**

The whole review system is monitored by the Quality Control Oversight Board, which has been created within JICPA to monitor the review system's efficiency and independence.

This Quality Control Oversight Board evaluates whether the Quality Control Review Committee and Team adequately performs the quality control reviews. This board is made up of five distinguished individuals (from among industry, the financial industry, the stock exchange, the media and academia) and the former JICPA President.

The Quality Control Oversight Board, for example, reviewed the whole process of the quality control review in the year, for example, which ended March 2001 and recommended a few important agenda items to the JICPA Quality Control Committee in July 2001 as follows:

- (a) Risk approach will be formally required in the new auditing standards to ensure widespread use of risk approaches among Audit Corporations and CPA offices.
- (b) Some small-to-medium sized firms have not ensured in written confirmation whether potential breach of independence exists between audit clients and audit supporting staff. Since auditor independence is one of the most important building blocks in external audits, it is highly recommended that JICPA prepare practical guidelines on this matter, including a revision of ethical rules.
- (c) Faced with increasing public attention over auditing, clearly determine whether the results of quality control reviews should be disclosed; and if it should be disclosed, what the criterion for disclosure will be, and what the method of informing to the public will be. Credible and transparent disclosure will enhance the integrity and fairness of the quality control review.

The Quality Control Oversight Board has been reformed in accordance with the creation of the CPA and Auditing Oversight Board that oversee the quality control review system as an independent third-party board that is established within FSA.

#### **(5) JICPA's reaction to the board's recommendations**

In accordance with the above recommendations, JICPA drafted a guidebook that explained the auditing techniques based on risk approaches especially for smaller firms to use as a reference in applying audit practices, and it also renewed rules on confirming the independence of auditors in November 2001 under the Implementation Guidance for Article 14 of the Code of Ethics, which are provided for reference in audit practices.

JICPA has decided to gradually increase its disclosure of Quality Control Review results to the public. JICPA continues to strive to ensure even more transparency by increasing the amount of information disclosed based on the results of the review.

## **5-2-2 Individual Engagement Review**

### **(1) The Audit Practice and Review Committee**

#### **1) Purpose and structure**

The purpose of the Audit Practice and Review Committee, which was established in 1978 in order to respond to reinforcement requirements of JICPA self-regulatory functions at that time, is to support JICPA members to properly perform and develop their auditing work. Namely, the Review Committee examines how the CPAs perform their auditing work and whether their audit opinions are well substantiated. The Review Committee picks out from the news covered in major newspapers' articles describing suspicions of window dressing in financial statements, fraudulent accounting, massive loss disclosures and bankruptcies. In addition, the Review Committee examines whistle-blowing information given to JICPA as necessary.

When the Review Committee decides upon review that the auditing work has been carried out in a considerably improper manner, it may give a corrective recommendation to the CPAs concerned. When the Review Committee determines that an audit client has exercised significantly improper accounting treatments, it may recommend to the relevant CPAs that they propose a correction of such improper accounting treatments as well as change their audit opinions. In the event that the Review Committee decides further examination is necessary from an ethical point of view, it refers the case to the Audit and Disciplinary Investigation Committee, where the case is investigated as to whether further procedures are necessary in the Ethics Committee.

Most importantly, the Review Committee holds a position that furnishes CPAs with guidance for strengthening their auditing work and does not go beyond the line of taking disciplinary actions against them.

The Review Committee consists of fifteen members of which seven are JICPA executive directors. Occasionally, the case being reviewed involves a company audited by an Audit Corporation to which one of the members of this Committee belongs. When a member has an interest in a case being reviewed by the Review Committee, that member may not participate in the decision making of the case. In addition, all the members of the Review Committee are held responsible for confidentiality. Consequently, any matters discussed or reviewed by the Review Committee will not be disclosed to the public.

#### **2) Review procedure and results**

The types of cases handled by the Review Committee are generally divided into (a) Suspicious engagement cases and (b) Concurring cases.

##### **(a) Suspicious engagements review**

When the Review Committee picks up a case, it first assigns two members who have no interests in the case, and then they make a written inquiry and set up an interview with the auditor in question as necessary. The Review Committee is entitled to require reports from CPAs for inquiring on matters thereof and to request submission of

reference material, as considered necessary for the purpose of the CPAs to carry out their audits (Article 89-2-2 of the JICPA Constitution). The examination results are reported and reviewed at a general meeting with the full committee member to be held once a month in principle.

The conclusions determined at the general meeting will be notified to the relevant CPAs in one of the following forms:

- i) The review was closed with no problems.
- ii) The review was closed with comments given to the pertinent CPAs.
- iii) The review was suspended for the time being, but the final decision is reserved until later since future moves need to be observed.
- iv) Recommendation as to improvement in certain audit procedures.
- v) Further examination is required from the Audit and Disciplinary Investigation Committee.



Breakdown of the review results of the Review Committee for the period from April 2001 to March 2002 are as follows:

Breakdown of the Cases	Number of Cases
Cases carried over from the previous period	
1) Securities and Exchange Law Audit	
Suspicion of window dressing	2
Massive loss reported	4
Bankruptcy	3
Other	2
2) Educational Institution Audit	
Miscellaneous	3
<b>Total</b>	<b>14</b>
Newly picked-up Cases	
1) Securities and Exchange Law Audit	
Suspicion of window dressing	4
Massive loss reported	2
Bankruptcy	21
Other	4
2) Commercial Code Audit	
Suspicion of window dressing	1
Bankruptcy	1
3) Educational Institution Audit	
Miscellaneous	1
<b>Sub-Total</b>	<b>34</b>
<b>Total number of cases reviewed in the period</b>	<b>48</b>
Cases concluded	
Review closed without any problem	4
Review closed with comments noted	10
Suspended	4
Sent to Audit and Disciplinary Investigation Committee	8
<b>Total</b>	<b>26</b>
Cases outstanding	22

(b) Concurring case review

The Review Committee also examines some issues that are broad in nature and not limited to certain audit engagements. There are two types: one is related to appropriateness of level of auditing practices such as unreasonably low fees, insufficient staff assignments or insufficient field work hours indicated in the summary report of individual audit engagements filed with JICPA. The other is related to emerging accounting issues.

Small study groups are formed for the respective cases. Then, with the leadership of the study group leaders, the cases are examined (including inquiries to particular CPAs as necessary) and analyzed. The conclusions and necessary actions are discussed at a general meeting of the Review Committee.

(i) With respect to the level of auditing practice issue, for example, the Review Committee has recently examined and discussed the following two cases:

At first, based upon audit summaries, the Review Committee examined and analytically compared the audits performed in the three consecutive periods from FY1998 to FY2000 in relation to the Securities and Exchange Law audit with a special focus on issues that are unique to each industry. The Review Committee finished analyzing the data and noticed some cases where sufficient auditing time and fees were not relatively secured in certain industries. The Review Committee, therefore, is considering measures to improve the quality of audits by those CPAs. Second, after discussions with the JICPA regional chapters, the Review Committee discovered that the usage rate for the independent review by other CPAs, which was a substitution measure for sole practitioners or small practices that have no independent review partner, is low. In response to this finding, the Review Committee is considering measures to be taken.

(ii) With respect to the emerging accounting issues, for example, the Review Committee recently pointed out an issue whether necessary accrued cost provisions are properly accounted for in the “sales-point system” in the financial statements of retail industries. The sales-point system was widely introduced as a means of promoting retail sales in which small portion of the sold amount is later paid back to customers in the form of goods or services. In order to conduct a field survey, the Review Committee randomly selected forty major companies in retail industries and implemented inquiries to the relevant CPAs. As a result, the Review Committee decided no special measure is required at the moment. However, it sent to the CPAs who responded to the inquiries results of its analysis and points to be noted in the auditing practice.

## **(2) Audit Practice Monitoring Board**

In order to improve the transparency of JICPA activities, the Audit Practice Monitoring Board was established as a permanent institution at the JICPA 2001 General Assembly. In December 2001, JICPA formally established the Audit Practice Monitoring Board, to:

- (a) Examine activities of the JICPA Audit Practice and Review Committee, the Ethics Committee and the Audit and Disciplinary Investigation Committee and,
- (b) Publish the annual report regarding JICPA’s audit practice monitoring to the public.

JICPA President initially chooses the board candidates. The board members are as follows: as Chairperson, the former JICPA President, and five other members: the director of the Tokyo Stock Exchange, a member of the Editorial Board/Editorialist of a leading newspaper company, an executive vice president of a large manufacturing company, a law professor at the University of Tokyo and a business professor at another university.

## **6. Corporate Governance and Oversight of CPAs**

### **6-1 Corporate Governance Structure of Japanese Corporations**

The corporate governance structure of Japanese companies consists of two organizations: the Board of Directors and the corporate statutory auditors. The board of directors of Japanese corporations usually performs both the management function as well as the oversight of each director and officer. Corporate statutory auditors are unique in the Japanese corporate governance structure. They are independent of the board of directors and oversee and monitor the board of directors and directors.

In a large corporation, which is either capitalized with 500 million yen or more, or has a total amount of liabilities of 20 billion yen or more, it is required to be audited by corporate statutory auditors, as well as by CPAs or an audit corporation (hereafter "external auditors") (Article 2 of the Audit Special Law)." Such large companies are also required to have at least three corporate statutory auditors, and at least one full-time corporate statutory auditor and at least one outside corporate statutory auditor under the Audit Special Law.

Pursuant to the Securities and Exchange Law, all listed companies and other companies that have raised capital from the public exceeding a certain number of subscribers and a certain number of subscriptions are required to have their financial statements audited by external auditors, namely CPAs or an Audit Corporation in addition to the Audit Special Law requirement (Article 193-2 of the Securities and Exchange Law). Accordingly, a large Japanese corporation is required to be audited in accordance with the requirements of the two different laws, the Commercial Code (Audit Special Law) and the Securities and Exchange Law.

In practice, the same external auditor is usually engaged to audit the company following both the Audit Special Law and the Securities and Exchange Law audits requirements. Audit standards and practices are the same for these two audit engagements; however, audit opinions of the external auditors are different in wording. External auditors' opinions prepared for the Audit Special Law requirement is published in an annual operation report together with financial statements to be sent to shareholders as an invitation to the general shareholders' meeting. Another audit opinion for the Securities and Exchange Law requirement is attached to the annual securities report to be filed with MOF's local finance bureaus after the general shareholders' meeting.

### **6-2 Oversight of external auditors**

#### **6-2-1 Appointment and dismissal of external auditors**

Under the Audit Special Law, external auditors shall be appointed at the general shareholders' meeting and consent of board of corporate statutory auditors to board of directors' proposal on the appointment of external auditors shall be necessary when board of directors proposes it to the shareholders' meeting (Article 3 of the Audit Special Law). Dismissal of the external auditors can be made at any time if it is approved by shareholders at the general shareholders' meeting (Article 6 of the Audit Special Law).

Corporate statutory auditors can dismiss external auditors due to their malpractice or health condition with subsequent report to the general shareholders' meeting (Article 6-2 of the Audit Special Law).

### **6-2-2 Oversight of external audits by corporate statutory auditors**

Monitoring of external auditors is important in the corporate governance structure, and corporate statutory auditors assume this responsibility in Japan. The Audit Special Law requires external auditors and corporate statutory auditors to have a close relationship in a due course of audits. At year-end, external auditors report results of their annual audit of the company's financial statements (Article 13 of the Audit Special Law). Each corporate statutory auditor is required to examine the external auditors' audit results and to report to the board of corporate statutory auditors and report each auditor's audit result to the board of directors (Article 14 of the Audit Special Law). Corporate statutory auditors are also required to report their audit results at the shareholders' meetings (Article 275 of the Commercial Code). In order to fulfill their duties, corporate statutory auditors usually request assistance of internal audit functions and external auditors. Corporate statutory auditors can also require external auditors to report on any issue at any time (Article 8, (2) of the Audit Special Law).

### **6-3 Corporate statutory auditors**

Corporate statutory auditors are important and indispensable in the corporate governance of a Japanese corporation. The Commercial Code and Audit Special Law protect their positions and carefully designs their duties and responsibilities.

#### **6-3-1 Appointment and dismissal of corporate statutory auditors**

Corporate statutory auditors are elected at the general shareholders' meeting where not less than one-third of the total number of outstanding shares is represented. The Commercial Code provides qualifications for corporate statutory auditors. A director or employee of the company or its subsidiary cannot be a corporate statutory auditor (Article 276 of the Commercial Code). Corporate statutory auditors are not required to be qualified public accountants.

A corporate statutory auditor has the authority to express opinions at the shareholders' meeting regarding the election of other corporate statutory auditors (Article 275-3 of the Commercial Code). The term of corporate statutory auditors is three years (Article 273 of the Commercial Code). This is one year longer than directors' term. The term of a corporate statutory auditor has been extended by a year in a recent revision of the Commercial Code so that a company will need to elect a corporate statutory auditor for a four-year term starting with the shareholders' meeting for the first fiscal year-end after May 1, 2002.

Shareholders may resolve to dismiss a corporate statutory auditor (Article 280, (1) of the Commercial Code) before expiration of the term. However, a corporate statutory

auditor has the right to claim to the company compensation for damages due to dismissal without justifiable cause. When a corporate statutory auditor wishes to state his/her opinion at the shareholders' meeting about the proposal for dismissing him/her, his/her opinion shall be summed up in a proxy statement that is distributed to shareholders (Article 275-3 of the Commercial Code).

A corporate statutory auditor may resign at any time. The revised Commercial Code empowers a resigning corporate statutory auditor to state his/her reason for the resignation at a shareholders' meeting (Article 275-3-2 of the Commercial Code). A company must send a notice of a shareholders' meeting to the resigning corporate statutory auditor.

If a company uses a proxy-voting method to obtain shareholders' decisions about the proposed agenda of the shareholders meetings, it has to include the summary of opinions of the resigning corporate statutory auditor in the proxy statement.

Other incumbent corporate statutory auditors are entitled to state their opinion about the resignation of a fellow corporate statutory auditor at the shareholders' meeting. Therefore, even if the resigning corporate statutory auditor has failed to come to the shareholders' meeting, other corporate statutory auditors can speak their views about the resignation of the fellow corporate statutory auditor at the shareholders' meeting.

The corporate statutory auditor's position is well protected. Company management cannot dismiss him/her at will because it has to call a shareholders' meeting and explain to shareholders why it wants to dismiss him/her.

### **6-3-2 Remuneration**

Remuneration for corporate statutory auditors must be set in the articles of incorporation or by a resolution at the shareholders' meeting, separately from the compensation for directors (Article 279, (1) of the Commercial Code).

### **6-3-3 Power and responsibility**

Corporate statutory auditors examine the activities of directors (Article 274 of the Commercial Code). They must attend the board of directors' meetings and express their views and opinions about company management (Article 260-3, (1) of the Commercial Code). When corporate statutory auditors believe any director's activities fall outside the company's business purpose or are in violation of laws or the company's articles of incorporation, they must report it to the other directors or request convening board of directors' meeting (Article 260-3, (2) of the Commercial Code). If there is a possibility that a director's action is in violation of laws or the company's articles of incorporation or if it will cause considerable damage to the company, then corporate statutory auditors have the power to request the director to stop the action (Article 275-2 of the Commercial Code). If a director discovers a fact that is expected to cause serious damage to the company, he/she shall immediately report it to a corporate statutory auditor (Article 274-2

of the Commercial Code).

If corporate statutory auditors fail to fulfill their duties, they are liable to pay compensation for damages. If they have neglected any of their duties, they should be jointly and severally liable in damages to the company (Article 277 of the Commercial Code). When corporate statutory auditors are at fault for not performing their duties properly, company directors are almost always responsible for damages to the company or shareholders. Therefore, when both directors and corporate statutory auditors are liable in damages either to the company or to a third party, they shall be jointly and severally liable (Article 278 of the Commercial Code).

### **6-3-4 Independence**

#### **(1) Each corporate statutory auditor has autonomous power and responsibility**

As described above, each corporate statutory auditor is independently required to examine directors' behavior and activities and external auditors' audit results and to report to the other corporate statutory auditors (Article 14 of the Audit Special Law). The board of corporate statutory auditors is not expected to make a resolution on the audit result as a board. Instead, each auditor's audit result must be independently reported to the shareholders' meeting because there may be differing opinions between or among corporate statutory auditors. This is because each corporate statutory auditor is independent, and each has a variety of skills and experience such as outside corporate statutory auditor or inside corporate statutory auditor; full-time corporate statutory auditor or part-time corporate statutory auditor.

#### **(2) Outside Corporate Statutory Auditor**

The present Commercial Code stipulates that out of three or more corporate statutory auditors, at least one must be an outside corporate statutory auditor. This outside corporate statutory auditor requirement was added to the Commercial Code in its 1993 revision. However, the number of outside corporate statutory auditors will be increased to at least half the total number of auditors in 2005 pursuant to the recent revision of the Commercial Code. Since the outside corporate statutory auditor system was introduced to provide objective audit over the directors' activities, the Commercial Code stipulated an independence rule. The Audit Special Law Article 18 (1) stipulates the definition of an outsider as someone who has not worked for the company as a director or an employee of the company or its subsidiary as a director or an employee.

The Commercial Code stipulates a restriction on who can be elected as an outside corporate statutory auditor. Before the recent revision of the Commercial Code, a former director or employee of the company or its subsidiary could be elected as an outside corporate statutory auditor as long as he/she had not been a director or employee of the company or its subsidiary for the last five years. In the revised Commercial Code, the five-year rule was changed. The new rule requires that an outside corporate statutory auditor must have never been a director, executive or employee of the company or its subsidiary. It is noted that a director, executive or employee of the parent

company can be an outside (corporate) auditor of its subsidiary.

#### **6-4 Newly Created Audit Committee Framework in Japan**

In early 2002, the Audit Special Law was amended to add an audit committee system as an alternative option to the present corporate statutory auditors system. This change was put into effect on April 1, 2003, making it possible for a Japanese company to establish an audit committee by dissolving the board of corporate statutory auditors. It should be noted that it is not mandatory for a Japanese company to establish an audit committee.

If a Japanese company establishes an audit committee, the Audit Special Law requires the audit committee to include at least three directors, and the majority of them must be outside directors. This means that if the committee consists of three directors, then two of them must be outside directors.

The audit committee system is linked to the executive officer system where the board of directors is designed to strictly supervise the CEO and his/her subordinates. Under the new system, the authority and responsibility of the position is clearly distinguished by a complete separation of officers such as the CEO and the directors who are often outsiders. Under this system, officers are responsible for the management of the company, but they are also accountable to the management-supervisory organization consisting of the directors. In the audit committee system, a company has to set up (1) an audit committee, (2) a nominating committee, and (3) a compensation committee.

## **7. Disciplinary Actions and Sanctions of CPAs**

### **7-1 JICPA**

#### **7-1-1 Audit Practice & Review and Audit & Disciplinary Investigation Committees**

The Audit Practice and Review Committee oversees CPAs audit practices and makes inquiries when they find any irregularities. As a result of inquiry, in the event that the Review Committee decides further examination is necessary from an ethical point of view, it refers the case to the Audit and Disciplinary Investigation Committee, where the case is investigated as to whether further procedures are necessary in the Ethics Committee.

The Audit and Disciplinary Investigation Committee consists of eight CPAs who are JICPA vice presidents, executive board members or council members. This committee must carefully study and investigate each case referred from the Audit Practice and Review Committee as to whether the case shows any violations of ethics or CPA requirements. When it is tentatively concluded that members under review may have violated the Code of Ethics, the Committee recommends that the President of JICPA requests the Executive Board to discuss whether the case is to be referred to the Ethics Committee for disciplinary actions or not (Article 89-3 of the JICPA Constitution, Article 5 (2) of Ethics Committee Rule).

When the Executive Board determines that the case should be referred to the Ethics Committee, the President asks the Ethics Committee to investigate the case for possible disciplinary action.

#### **7-1-2 Ethics Committee**

The Ethics Committee consists of twenty-seven members who investigate CPAs or Audit Corporations involved in the referred cases. CPAs are subject to inquiry and requirements of reporting and submitting of necessary materials to the Ethics Committee (Article 8 of Ethics Committee Rule). Disciplinary sanctions are as follows: a) a reprimand, b) a suspension of the right of a member for a certain period, and c) a request to FSA to revoke the CPA's or Audit Corporation's qualifications and other sanctions stated in the CPA Law. For junior CPAs, the Ethics Committee may expel them from JICPA's membership.



The following table shows the disciplinary actions taken by JICPA between 1990 and 2002.

Year	Audit failures resulted in suspension, revocation or reprimand	Violation of the Licensed Tax Accountant Law or other resulting in suspension or other	Failure to pay membership dues resulted in suspension of memberships	Failure to pay membership dues resulted in expulsion of junior accountants
1990			2	
1992			3	
1993	2 suspensions 1 reprimand			
1995			8	
1996			8	3
1997 <sup>(1)</sup>	1 suspension		7	
1998			11	
1999	1 revocation request to FSA		10	2
2000 <sup>(2)</sup>	1 suspension <sup>ii)</sup>		6	
2001 <sup>(3)</sup>		3 suspension	1	
2002 <sup>(4)</sup>	1 suspension of audit corporation	1 suspension 1 reprimand t	13	6 junior CPAs were removed
Total	7	5	69	11

## 7-2 FSA

The Audit Corporations and CPAs are subject to the requirements of reporting and submitting necessary materials to FSA (Article 49-3 of the CPA Law) and are subject to disciplinary sanctions including suspension of practice or revocation of qualification registration or approval of establishment (Articles 29 through 31, and 34-21 of the CPA Law). Under the CPA Law Article 46-10, when JICPA finds facts regarding its members that fall under a disciplinary provision, it is required to report them to FSA. FSA hears the opinions of the CPA and Auditing Oversight Board that reflects public opinion before FSA determines what sanctions are appropriate for CPAs and/or Audit Corporations.

FSA makes public notices of its disciplinary actions (Articles 34, (3) and 34-21, (2) of CPA Law). For example, in October 2002 FSA made a public notice of revocation of two CPAs who conducted a faulty audit on a transportation company. In addition, a FSA disciplinary action was made public: a suspension of the auditing practice of an Audit Corporation for one year was posted in FSA homepage. The penalty to suspend practice of an Audit Corporation virtually means its closure because it is not permitted to provide auditing services to any of its clients for a year. In fact, audit clients of the aforementioned Audit Corporation changed auditors one after another as soon as the practice suspension was made public.

The following table shows the disciplinary actions taken by FSA between 1990 and 2002.

Year	Revocation of registration of CPAs	Suspension of practice	Reprimand
1993		2 (suspensions)	1 (for an audit firm)
1997 <sup>(1)</sup>			
1999	1 (due to audit failure)		
2000 <sup>(2)</sup>		2 (CPAs) <sup>i)</sup> 1 (CPA) <sup>ii)</sup>	1 (an audit corporation) <sup>i)</sup> 2 (CPAs) <sup>ii)</sup>
2001 <sup>(3)</sup>	1 (insider trading violation)	2 (due to violation of Tax Accountants Law)	
2002 <sup>(4)</sup>	2 (due to an audit failure)	2 (due to violation of Tax Accountants Law) 1 (an audit corporation)	
Total	4	10	4

In some years discrepancies exist between the disciplinary actions of FSA and JICPA. Here is a year-by-year summary.

- (1) In 1997, JICPA suspended the membership of a CPA. However, the MOF (presently FSA) did not reprimand this CPA.
- (2) In 2000, i) an Audit Corporation and its two partners were involved in an audit failure. JICPA withheld disciplinary action for these three members because they were involved in civil litigation. However, FSA suspended the qualifications of the two CPAs for months and gave a reprimand to the Audit Corporation, and ii) a CPA in charge and two supporting CPAs were involved in another audit failure. JICPA and FSA suspended the qualifications of the CPA for months. As for the two supporting CPAs, FSA reprimanded them, but JICPA did not.
- (3) In 2001, a CPA, who enriched himself from insider information, was sentenced to imprisonment for one year. As a result, FSA revoked this CPA's registration. However, JICPA was unable to do any disciplinary action since he was arrested and not available for JICPA questioning. In addition, both FSA and JICPA suspended the two CPAs' practice licenses because they evaded their own income taxes. Another CPA was alleged to have embezzled money, and JICPA suspended his practicing license. However, FSA did not suspend his practicing license because the lawsuit was not finalized yet.
- (4) In 2002, an audit corporation and its two partners were involved in an audit failure. FSA revoked the practicing licenses of the two CPAs and suspended the license of the Audit Corporation. Since FSA revoked the practicing licenses of the CPAs, these CPAs were no longer members of JICPA. Therefore, JICPA was no longer able to remove or suspend the CPAs' licenses.

### **7-3 Civil Sanctions**

Articles 21, 22 and 24-4 of the Securities and Exchange Law provide that a securities issuer's management and external auditors may be liable to compensate for damages resulting from the false statements or omissions in securities registration statements or annual securities reports.

Article 9 of the Audit Special Law requires that if the external auditors have caused damages to the company due to negligence of their duties, such external auditors shall be liable to jointly and severally compensate the company for damages. Article 10 of the Audit Special Law requires that if the external auditors have caused damages to a third party by having made a false statement in the audit report required by the Audit Special Law, such external auditors shall be jointly and severally liable for the damages to the third party. However, if the external auditors prove that they had not failed to exercise due care in performing their functions, then they will not be held responsible for damages. Article 11 of the Audit Special Law also requires that in the case where the external auditors are liable to compensate the company or a third party for damages, the directors or the corporate statutory auditors are also liable, the external auditors, directors and corporate statutory auditors are all jointly and severally liable.

Japanese Audit Corporation partners are required to assume unlimited liabilities even when the partner himself/herself is not personally responsible for the cause of the lawsuits.

### **7-4 Criminal Sanctions**

The Securities and Exchange Law requires that any person who prepares a false securities registration prospectus or annual securities report filed with MOF local finance bureaus shall be imprisoned for not more than five years and/or fined not more than five million yen (500 million yen, in case of accused juridical person) (Articles 197 and 207 of the Securities and Exchange Law).

The Audit Special Law requires that any external auditor who obtains, by means of false or fraudulent pretenses, or who requires or promises any money in connection with his/her duties, shall be imprisoned for not more than five years or fined not more than five million yen (Article 28 of the Law).

# Supplement: Illustration of Auditor Oversight in Japan

