Japan Moving to Deter Accounting Fraud
– Tougher Rules for Businesses, Accountants –

By Aoki Masaru

IN response to a series of accounting frauds deceiving investors as found at such firms as Kanebo Ltd., Livedoor Co. and Nikko Cordial Corp., the Japanese government has been stepping up efforts to prevent such irregularities in the books. Publicly traded companies will be required to prepare "internal control reports" and publish them after their attestation by public accounting firms annually from the year starting in or after April 2008. An internal control report is supposed to include management's certification of financial statements as adequate. The government has submitted a bill to parliament to amend the Certified Public Accountants Law, including measures to toughen penalties on accounting firms and regulations to deter cozy relations between accountants and their client companies. One of the measures would create a fine to be imposed on an accounting firm involved in a client company's accounting fraud. Concerned about accounting firms' engagement in the series of financial frauds, the government has devised these measures to encourage them to strictly audit corporate financial statements.

The internal control report system is a Japanese version of the US Public Company Accounting Reform and Investor Protection Act of 2002, known as Sarbanes-Oxley Act, which was enacted in response to Enron Corp.'s high-profile massive accounting fraud. The system has been introduced to secure investor confidence in corporate financial statements under the Financial Products Exchange Law, which was enacted in June 2006. All of about 3,800 publicly traded Japanese firms are subject to the system, and they will be required to prepare their first internal control reports by the end of the fiscal year starting in or after April 2008.

The Business Accounting Council, an advisory panel to the Financial Services Agency commissioner, finalized the rules for the implementation of the internal control report system for submission to Financial Services Minister Yamamoto Yuzo in February. The rules specify how publicly traded companies should develop internal systems to prepare reliable financial statements and how public accountants should audit these systems and statements.

The rules require businesses to subject operations at important divisions to internal control assessment, giving a threshold of "two-thirds of total consolidated sales." This means that a company is required to check for any accounting irregularities in operations accounting for a maximum "two-thirds" in combined sales at most important divisions including head office segments, key branches and large subsidiaries. The rules are thus designed to prevent the new burden from being too heavy on companies.

The rules also specify false data covering more than "5% of consolidated pre-tax profit" as a "grave defect" that would have to be spelled out in an internal control report unless it is corrected by the end of a fiscal year.

While the internal control report system is being introduced, legal experts point out that some publicly traded companies have yet to launch internal control. Particularly, young companies have failed to establish internal control systems, as indicated by the accounting fraud at Livedoor, a major Internet portal operator. It is uncertain if all publicly trade companies will complete internal control systems to prevent accounting fraud by the end of fiscal 2008.

The Financial Products Exchange Law also forces all publicly traded companies to publish quarterly financial statements from April 2008 for prompt information disclosure to investors. All companies will be obliged to publish quarterly financial statements within 45 days after the end of each quarter. This could force some companies to further accelerate periodical settlement of accounts.

The Certified Public Accountants Law amendment bill is based on recommendations that the Financial System Council, an advisory panel to the prime minister, presented in December last year on the reform of the certified public accountant and auditing firm systems. An auditing firm system reform will be the first in some 40 years.

The government has given up introducing criminal penalties on accounting firms in the bill. While the existing Securities and Exchange Law subjects individual public accountants to criminal penalties, the Financial System Council considered imposing criminal penalties on firms employing accountants held responsible for illegal practices. But it has left the matter for further consideration, concluding that such penalties involve legal problems and thus may fail to help deter accounting fraud.

The bill would diversify administrative punishments of accounting firms, introducing orders for improvement of business practices and dismissal of accounting firm directors, as well as administrative fine-payment orders for accounting firms that have approved false financial statements. Existing administrative punishments are limited to three measures – a warning without any fine, a business suspension order and a dissolution order. These orders can affect clients of accounting firms and are difficult to give. The bill would introduce new punishments positioned between the warning and orders, allowing the government to flexibly punish accounting firms. It would also allow a fine-payment order to be combined with a business suspension order, a business improvement order or a warning, paving the way for effectively tougher administrative punishments.

An administrative fine-payment order would be given to an accounting firm that has endorsed false accounting practices in the past seven years. An accounting firm that intentionally overlooked any illegal accounting practice at a client company would be ordered to pay a fine that would

Photo: Kyodo News

Okuyama Akio (2nd from left), head of ChuoAoyama Pricewaterhouse Coopers (disbanded later), bows in a show of apology after the auditing firm was ordered to suspend part of its operations for two months in mid-2006 for its involvement in financial data fabrication by Kanebo Ltd.

be 1.5 times as much as an accounting fee income from the client company for the year when the practice was conducted.

The introduction of new administrative punishments would be combined with the enhancement of supervisory and inspection systems. The Certified Public Accountants and Auditing Oversight Board under the control of the Financial Services Agency would be allowed to directly raid accounting firms suspected of having problems. The bill would also create a reporting system for foreign accounting firms and subject these firms to the board's inspection and supervision. It would revise the present rule where accounting firm employees who are not involved directly in auditing can be held responsible for auditing defects. Specifically, the bill would create a system of limited-liability accounting firms where employees would not be responsible in such cases.

In order to ward off cozy ties between accounting firms and their client enterprises, the bill would toughen regulations on the employment of public accountants who quit accounting firms. It would prohibit quitting accountants from getting executive posts not only at former client companies but also at their subsidiaries and affiliates. The bill would also require accountants to inform regulatory authorities of any accounting irregularities found during their auditing unless such irregularities are corrected in spite of due recommendations.

The maximum period of time for a team leader of a large accounting firm to remain in charge of auditing a publicly traded company would be shortened to five years from seven years at present. Furthermore, an interval of at least five years would be required before the team leader is allowed to resume auditing of the same company. The current minimum interval is two years.

Under the bill, those other than public accountants would be qualified as employees of auditing firms. This would allow lawyers, computer system engineers and other experts to take part in the management of auditing firms at a time when auditing operations grow more complex and sophisticated on diversification, complication and globalization of business activities. Auditing firm employees other than public accountants would have to be registered as special employees at the Japanese Institute of Certified Public Accountants. A limit would be put on these special employees' share of total employees at an accounting firm or on its decision-making board.

The bill would also set up rules for accounting firms' information disclosure. These firms would be required to prepare documents for disclosure of business and financial data. They would be allowed to publish these data on their websites.

Accounting firms' involvement in accounting fraud scandals has considerably hurt public confidence in these firms. ChuoAoyama Pricewaterhouse Coopers, whose clients included global leading businesses such as Toyota Motor Corp. and Sony Corp., was ordered by the Financial Service Agency to suspend operations for two months from July 2006 for its involvement in falsification of data in Kanebo's financial statements.

When it resumed operations on September 1, 2006, it renamed itself as Misuzu Audit Corp. Later, however, Nikko Cordial was found to have illegally inflated its consolidated earnings for its business year through March 2005 when ChuoAoyama was in charge of auditing the third largest Japanese securities company. Concerned that the scandal would further hurt Misuzu's trustworthiness, the firm decided in February 2007 to effectively dissolve itself by transferring most of accounting operations to its three rivals – Ernst & Young ShinNihon, Deloitte Touche Tohmatsu Japan and KPMG AZSA & Co.

The fate of ChuoAoyama looks similar to that of Arthur Andersen LLP, a major US accounting firm that was dissolved after its involvement in the Enron scandal. In July 2006, Ernst & Young ShinNihon, Deloitte Touche Tohmatsu and KPMG AZSA, as well as ChuoAoyama, were instructed by the Financial Services Agency to improve their business practices under the Certified Public Accountants Law on the ground that their operations for controlling the quality of auditing services were inadequate. Such operations included compliance with laws, procedures to secure auditors' independence from client companies, and preparation and preservation of audit records.

In discussions on the bill, the Financial System Council once tried to reform the current system where the management side of companies is authorized to determine audit fee payments to accounting firms. The system was criticized as a factor prompting accounting firms to ease audit operations. The council then considered shifting the fee-determining power to client companies' internal auditors. But this measure was found as amounting to a corporate law amendment that the Ministry of Justice should address. It has eventually been set aside for future consideration.

A proposal that requires companies to regularly rotate auditing firms has dropped out on a complaint that such rotation would not be realistic with the number of auditing firms limited to only four. A proposed periodical review and renewal of public accountant qualifications have also been shelved. Given these shelved proposals, it is doubtful if the bill would successfully fend off cozy relations between accounting firms and their client companies that are viewed as causing accounting fraud. Calls may grow for further legal reforms. JS

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