CASE 8.3

Kansayaku

Kokai saki ni tatazu [repentance never comes first]

Japanese proverb

Satoshi Hirata served on the audit staff of Asahi, one of Japan's four largest public accounting firms.[1] Like its three principal rivals, Asahi was affiliated with one of the Big Four international accounting firms, namely, KPMG. Throughout the spring of 2003, Hirata had been assigned to the audit of Resona, a large metropolitan bank. The bank was being audited jointly by Asahi and Shin Nihon, the Japanese affiliate of Ernst & Young. On April 24, 2003, after completing his work for the day on the Resona engagement, Satoshi Hirata returned to his 12-story apartment building in central Tokyo, went to the roof of that building, and leaped to his death.

Disloyal Auditors

Although Satoshi Hirata did not leave a note explaining his decision to take his life, law enforcement authorities subsequently learned that the young auditor was distressed by his job. At the time, Resona and Japan's other major banks were experiencing major financial problems. For well over a decade, Japan's handful of "megabanks" had routinely embellished their reported financial health by, among other means, refusing to provide adequate reserves for their expected loan losses. In the spring of 2003, Resona's financial condition had deteriorated to the point that its independent auditors doubted the bank could survive without a large infusion of capital from another bank or the federal government.

Hirata, one of the subordinate auditors on Resona's joint team of Asahi and Shin Nihon auditors, knew that Resona was technically insolvent and had been for years despite the fact the bank had received unqualified audit opinions each year on its annual financial statements. Hirata was apparently concerned that his superiors would issue a similar opinion at the conclusion of the audit to which he was assigned. According to one newspaper report, Mr. Hirata's suicide was intended as a "dramatic gesture to persuade his seniors that Japan could no longer afford to keep covering over the cracks."[2] The "cracks" referred to in this quotation were the huge and unreported financial problems facing Resona and Japan's other major banks.

Following Mr. Hirata's death, Asahi withdrew from the Resona audit engagement. Asahi's resignation meant that Shin Nihon would be forced to decide the large bank's future. Resona's president, Yasuhisa Katsuta, a prominent political power broker in Japan, never doubted that Shin Nihon would give his bank a clean bill of health. But he was wrong. When the Shin Nihon auditors insisted that the bank seek outside financing to remedy its financial problems, Katsuta accused them of "betraying" his firm.[3] A few days after the auditors refused to give Resona an unqualified audit opinion, Japan's federal government announced that an emergency infusion of government funds equivalent to $17 billion was necessary to rescue the bank from

1. "Kansayaku" is a generic term for "inspector" or "auditor" in the Japanese language.
2. M. Nakamoto and D. Pilling, "Resona's Downfall," *Financial Times*, 13 June 2003, 11.
3. *Ibid.*

imminent bankruptcy. To fully understand Mr. Katsuta's reaction to Shin Nihon's decision, it is necessary to study the history of Japan's banking system and its independent audit function.

Okurasho

By the end of World War II, Japan's economy was practically destroyed. Over the following five years, General Douglas MacArthur of the U. S. Army supervised the post-war occupation of Japan by the Allied Powers. In carrying out his mission to convert the Japanese nation into a democracy and to establish a free market economic system within the country, General MacArthur largely succeeded in his attempt to dismantle Japan's ancient political and economic infrastructure. But one important feature of that infrastructure, the secretive and powerful Okurasho, was left largely unscathed by General MacArthur's purge.

From the seventh century A.D. through World War II, the Okurasho or "great storehouse ministry" was responsible for overseeing the economic development and well-being of the Japanese nation. Often referred to by political insiders as the "ministry of ministries," the Okurasho was a tightly knit group of powerful and wealthy individuals who advised the Japanese emperor on all major economic decisions facing the country and who effectively controlled the nation's banking system. In the Japanese economy, the banking system has historically been very powerful because the principal source of funds for private businesses has been debt rather than equity capital. The Okurasho also played a major role in overseeing Japan's stock market when it became a significant factor in the Japanese economy during the twentieth century.

Because senior members of the Okurasho chose each successive generation of the organization's leaders, the organization was self-perpetuating. In fact, the individuals who controlled the organization pressured their children to marry only members of other Okurasho families. Because General MacArthur was unaware of the Okurasho's far-reaching influence within Japan's social structure and economic system, members of the clandestine organization resurfaced following World War II and quickly took control of the Ministry of Finance (MOF), the government agency that would be responsible for managing the country's economy when the post-war occupation of Japan ended.

Despite the democratic political system imposed on Japan by General MacArthur, the country's elected officials had only minimal input into the post-war economic policies established by the MOF. Few of those officials ever questioned the MOF's heavy-handed, if not authoritarian, policies since those policies were responsible for the rapid modernization and recovery of the Japanese economy following World War II. Within four decades, the MOF's policies created the second-largest economy in the world and produced a level of economic prosperity surpassed only by the U.S. economy.

During the 1990s, President Clinton frequently criticized the MOF for its protectionist international trade policies that resulted in the United States having a huge and unfavorable trade imbalance with Japan. President Clinton charged that the secretive agency prevented Japan from becoming a "fully modern state with fair and open trade."[4] A *Business Week* report provided a similarly blunt assessment of the MOF's role in Japan's economy. "Japan's Ministry of Finance is much more than an office of

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4. *BusinessWeek Online*, "The Ministry: How Japan's Most Powerful Institution Endangers World Markets," 25 September 2006.

government. It is a political, economic, and intellectual force without parallel in the developed world. It enjoys a greater concentration of powers, formal and informal, than any comparable body in any other industrialized democracy. In Japan, there is no institution with more power."[5]

By the early 1990s, Japan faced its first major financial crisis since World War II. Various economic factors and conditions prevented Japan from sustaining the impressive growth that it had experienced over the previous decades. Suddenly, Japan's economy faced many of the same problems that have frequently plagued the U.S. economy over the past century: volatile interest rates, inflation, and surging unemployment. These problems caused Japan's stock market to decline sharply and eventually led to a startling number of business failures.

The large number of business failures during the 1990s produced huge losses in the loan portfolios of the major metropolitan banks that were the principal source of Japan's investment capital. However, the extent of the loan losses was not reported in the audited financial statements released periodically by those banks. Pressure applied by MOF officials on the auditors of Japan's large banks resulted in those banks receiving clean audit opinions despite their massive financial problems. Eventually, both the MOF and the nation's major accounting firms would be held responsible for the huge government bailouts that were necessary to rescue Resona and other large Japanese banks.

Japan's Independent Audit Function

A small number of large accounting firms have dominated Japan's accounting profession and independent audit function since World War II. In turn, the MOF effectively controlled those large accounting firms over most of that time frame, wielding power over them similar to the power that it wielded over the nation's major banks. In 1998, the founder of one of Japan's major accounting firms told a U.S. journalist that the large government agency "really controls the accounting profession in Japan."[6] So complete was the MOF's control of the accounting profession that it reportedly hand-picked the individuals who were to serve in key executive positions at the country's largest accounting firms. In the late 1990s, the chief executives of four of Japan's six largest accounting firms had previously worked in some capacity with the MOF. The close ties between the MOF and the major accounting firms meant that the top executives of those firms routinely kowtowed to the wishes and demands of MOF officials.

Japan's public accounting profession is much smaller than that of the United States. In the United States, there is one CPA for approximately every 800 citizens, while in Japan there is one CPA for approximately every 9,600 citizens. In fact, Japan has fewer CPAs per capita by far than any other major industrialized country. The relatively small number of CPAs in Japan is due in large part to the onerous requirements for becoming a CPA. Until 2006, CPA candidates in Japan were required to pass three rigorous examinations and serve a three-year internship with an accounting firm before they could become a CPA.

The large accounting firms in Japan that dominate the nation's accounting profession also audit the great majority of the country's public companies, large private companies, and other important organizations in the private and public sector. Approximately 10,000 Japanese companies must be audited each year, including the approximately 4,000 companies that have securities listed on public stock exchanges. The remaining

5. *Ibid.*

6. L. Berton, "Japanese Accounting Bites Back," *Accounting Today* (online), 9 November 1998.

companies that must be audited include unlisted corporations that have total capital exceeding 500 million yen and corporations that receive government subsidies.

Similar to the United States, the number of major accounting firms within Japan has been declining in recent years, principally due to mergers. By 2006, Japan's Big Four included ChuoAoyama—an affiliate of PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young Shin Nihon, and KPMG AZSA & Co. The latter firm was created in 2004 when Asahi, the firm that employed Satoshi Hirata, merged with another large Japanese accounting firm.

The nature, purpose, and structure of independent audits are generally very similar in Japan and the United States. However, there is one significant difference. Audit fees in Japan are dramatically lower than in the United States. The audit fee for a large Japanese company is generally one-tenth of the fee for a similar U.S. company. The much smaller audit fees charged by Japanese accounting firms impose severe restraints on the scope of independent audits and result in audit services being considerably less profitable for Japanese accounting firms than for their U.S. counterparts.

In the United States, the business press, financial analysts, and regulatory authorities maintain that an absence of auditor independence was a key factor that contributed to the series of high-profile audit failures of such companies as Enron, WorldCom, and Adelphia Communications, among others. Allegedly, the long tenure of auditors with their clients, personal relationships between individual auditors and client personnel, and the large consulting fees that clients paid their auditors for nonaudit services made it difficult for audit firms to objectively report on major clients' financial statements. However, parties familiar with auditing practices and norms around the world insist that Japanese auditors have historically had much closer ties to their clients than auditors in any other country, including the United States.

The cordial relationship between Japanese auditors and their clients is at least partially a cultural phenomenon because the Japanese business community "emphasizes relationships and harmonious working practices."[7] A critic of the Japanese public accounting profession suggested that this cultural norm results in Japanese auditors subordinating their judgment to the wishes or demands of their clients. "Even when corporate clients ask the auditors to do something that isn't allowed under the law, they just do it."[8]

By the late 1990s, Japan's independent audit function faced a growing credibility crisis. "In the late 1990s, problems with the current audit system started coming to light—exposed by a series of deplorable events at many corporations, including fraudulent accounting and the abrupt failure of financial institutions once considered healthy."[9] Worsening that credibility crisis was the fact that the principal regulatory authority for the public accounting profession, the MOF, rarely imposed sanctions of any kind on auditors who had failed to fulfill their professional responsibilities. In 1999, the MOF revoked a CPA's license to practice for the first time in more than 20 years.

Mounting frustration with the MOF's failure to take measures to strengthen Japan's independent audit function was one of several factors that resulted in the powerful agency being stripped of much of its regulatory authority near the turn of the century. The MOF lost even more of its authority following the election of Junichiro Koizumi as Japan's prime minister in 2001. The reform-minded Koizumi hoped to revitalize

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7. D. Reilly and A. Morse, "Japan Leans On Auditors to Be More Independent," *post-gazette.com*, 18 May 2006.

8. *Ibid.*

9. *The Yomiuri Shimbun* (online), "CPA-Client Collusion Must Be Severed," 10 August 2006.

Japan's stagnant economy by enhancing the "transparency" of the nation's capital markets. To accomplish that objective, Koizumi realized that the arcane regulatory structure for those markets had to be overhauled.

Under Prime Minister Koizumi's leadership, a new federal agency, the Financial Services Agency (FSA), assumed most of the responsibility for monitoring Japan's capital markets—including the nation's banking and financial reporting systems. To assist the FSA in overseeing the independent audit function and accounting profession, the new federal agency was placed in charge of the newly created Certified Public Accountants and Auditing Oversight Board (CPAAOB), which is comparable to the Public Company Accounting and Oversight Board (PCAOB) in the United States. To police the securities markets, another new federal agency, the Securities and Exchange Surveillance Commission, was established and placed under the FSA's control.

In 2004, Japan's federal legislative body, the Diet, rewrote the Certified Public Accountants Law. A major purpose of revising this law was to increase the number of CPAs in Japan. Among other changes, the revised law requires CPA candidates to pass only one examination rather than three to become a CPA. The national organization of CPAs, the Japanese Institute of Certified Public Accountants (JICPA), also adopted a series of measures to strengthen the profession, many of which focused on the independent audit function. Among these latter measures was prohibiting independent auditors from having any direct financial interest in a public client. Previously, auditors of public companies had been allowed to own a limited number of shares of a public client's outstanding stock.

The first major test of Japan's new regulatory structure for the accounting profession and independent audit function was posed by a financial scandal involving a large manufacturing company, Kanebo, Ltd. The nation's business press often refers to the Kanebo fiasco as "Japan's Enron."[10]

Kanebo, Ltd: Japan's Enron

The Tokyo Cotton Trading Company was founded in 1887 on the banks of the Sumida River that flows through Tokyo. Over the following decades, the company became a large and prosperous textile and apparel manufacturer—only to have its operating facilities totally destroyed during World War II. With the help of significant bank loans, the company, renamed Kanebo, Ltd., resumed operations on a much smaller scale in the late 1940s. By the late 1990s, the company ranked among Japan's largest public corporations. Kanebo's principal operations included the manufacture and sale of a long line of cosmetics, apparel, textiles, pharmaceuticals, toiletries, and food products.

In July 2005, Japanese law enforcement authorities arrested three former Kanebo executives, including Takashi Hoashi, the company's former president. The three individuals were charged with violating the Securities and Exchange Law, the principal federal statute that established the regulatory framework for Japan's securities markets, a statute comparable to the federal securities laws passed by the U.S. Congress in the early 1930s. Allegedly, the former Kanebo executives conspired to conceal their company's deteriorating financial health beginning in the 1990s. Throughout the time frame that the fraud was being perpetrated, Kanebo's audited financial statements indicated that the company was in reasonably good financial condition. However, a criminal investigation revealed that the company was hopelessly insolvent from 1995 through 2004.

10. *Accountancy* (accountancymagazine.com), "ChuoAoyama faces £100m Revenue Hit," 31 May 2005.

According to a representative of Tokyo's Public Prosecutor's Office, Hoashi ordered Kanebo's accounting staff to falsify the company's accounting records. Hoashi reportedly told the accountants that if they did not cooperate, the company would fail and its employees would lose their jobs. Hoashi's two subordinates (who were also indicted) gave the company's accountants specific instructions on how to distort Kanebo's reported financial data. The accountants were told to record fictitious sales and to understate various expenses to improve Kanebo's operating results and to make the company appear solvent.

In March 2006, Takashi Hoashi and one of his subordinates pleaded guilty to falsifying Kanebo's financial statements.[11] In commenting on the fraud, the judge who would ultimately sentence the two former executives noted, "It was a vicious and organizational crime committed by the leaders of a major Japanese company. It was also unprecedentedly cleverly devised."[12] Despite the judge's harsh remarks, he gave the two former executives suspended prison sentences.

ChuoAoyama, the second-largest CPA firm in Japan, served for decades as the audit firm of Kanebo Ltd. Tokyo's Public Prosecutor's Office filed fraud charges against three ChuoAoyama auditors who had been assigned to the Kanebo audit engagements. Each of those auditors had worked on the annual audits of that company for more than 15 years. One of the defendants had been assigned to the Kanebo engagement team for more than 30 years. In fact, it was common in post-World War II Japan for the same team of auditors to be assigned to an audit client indefinitely. According to the prosecutors, the three ChuoAoyama auditors had not only been aware of Kanebo's true financial condition but had also recommended additional methods for concealing the company's poor financial health. Among these methods was "deconsolidating" certain Kanebo subsidiaries that were posting large operating losses each year. The defendants never admitted as much, but the prosecutors speculated that the three auditors learned of this scheme from reading published reports of the Enron accounting fraud in the United States.

In the summer of 2006, the case against the ChuoAoyama auditors went to trial in Tokyo District Court. As one journalist noted, Japan's public accounting profession was "turned on its head"[13] by the case because it represented the first time in the country's history that auditors from a major CPA firm had faced criminal charges for allegedly falsifying or helping to falsify a client's financial statements. A few years earlier, ChuoAoyama had been involved in a precedent-setting civil lawsuit in Japan. ChuoAoyama had been the longtime auditor for Yamaichi Securities, a large brokerage firm that unexpectedly collapsed in late 1997. The following year, Yamaichi's former stockholders sued ChuoAoyama, charging that the firm had negligently audited Yamaichi. The lawsuit was the first of its kind filed by Japanese stockholders against an audit firm. In 2003, ChuoAoyama settled the lawsuit by agreeing to pay the Yamaichi bankruptcy administrator an amount equal to the total audit fees it had received for its final five annual audits of Yamaichi. Despite the settlement, ChuoAoyama officials insisted that the firm had properly performed those audits.

During the criminal trial of the three ChuoAoyama auditors, the defendants testified that shortly before the Kanebo fraud was uncovered by law enforcement authorities they had pleaded with Hoashi and his subordinates to make the proper correcting

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11. No published report could be found regarding the resolution of the criminal charges filed against the third Kanebo executive.

12. *Associated Press* (online), "Ex-Kanebo Executives Sentenced for False Information," 27 March 2006.

13. *International Accounting Bulletin* (online), "Japan Confronts Its Audit Problem," 12 August 2006.

entries in the company's accounting records. According to the three auditors, the client executives refused to make those entries. When the auditors pressed the issue, the Kanebo executives "secured their cooperation by pointing out that ChuoAoyama had long overlooked the company's window dressing and said it was pointless to start complaining after taking a complacent stance for so long."[14]

In August 2006, the three ChuoAoyama auditors were convicted of the charges filed against them. Before sentencing the three individuals, the presiding judge noted that they had "damaged the social trust of certified public accountants" and that their "crimes deserve to be severely criticized."[15] The judge also observed, "It is shameful that they have failed to realize the high professional morality as certified accountants and lost the true aim of auditing, which is to protect investors."[16] After berating the three convicted auditors, the judge gave each of them suspended sentences ranging from one year to 18 months. The judge defended the suspended sentences by pointing out that Kanebo's executives, not the three auditors, were primarily responsible for the fraudulent scheme. The suspended prison sentences for the three auditors meant that no one involved in the large-scale Kanebo fraud would serve any time in prison for their misdeeds.

In May 2006, the FSA announced that the three ChuoAoyama auditors involved in the Kanebo fraud would have their CPA qualifications revoked. The FSA also announced that ChuoAoyama would be forced to suspend its operations for the two-month period July 1–August 31, 2006. The announcement of the suspension stunned Japan's public accounting profession. Japan's Securities and Exchange Law requires each listed company to have an independent audit firm at all times. The suspension of ChuoAoyama meant that the firm's approximately 800 clients that had securities listed on a stock exchange would be forced to either retain a temporary auditor for the two-month suspension period or dismiss ChuoAoyama and retain a new audit firm.

EPILOGUE

To prevent Kanebo Ltd. from being forced to liquidate, the Japanese federal government placed the company in a "rehabilitation" program under the direction of the Industrial Revitalization Corporation of Japan (IRCJ). The government-sponsored and government-funded IRCJ had been created in April 2003 to help financially distressed companies obtain the capital they needed to survive and to provide them with "turnaround" advice from professional business consultants. Under the leadership of the IRCJ, Kanebo sold off its large cosmetics subsidiary and received more than $1 billion in government-guaranteed loans and waivers of outstanding loans. In 2006, a large investment fund purchased a majority of Kanebo's stock and took over control of the company from the IRCJ.

ChuoAoyama lost approximately one-third of its audit clients, including more than 200 publicly listed clients, during the two-month suspension imposed by the FSA. These companies included ChuoAoyama's two highest-profile audit clients, Sony Corporation and Toyota Motor Corporation. While serving the suspension, ChuoAoyama underwent an extensive internal review to strengthen its quality control functions and changed its name to the Misuzu Audit Corporation.[17]

14. *Japan Economic Newswire* (online), "Japanese Editorial Excerpts," 11 August 2006.

15. J. Hong, "CPAs in Kanebo Fraud Avoid Prison," *Japan Times* (online), 10 August 2006.

16. *Agence France Presse* (online), "Ex-Accountants Found Guilty in Japanese Fraud Case," 9 August 2006.

17. In February 2007, Misuzu announced that it was disbanding. The remaining three members of Japan's former Big Four hired the majority of Misuzu's employees.

EXHIBIT 1

Excerpt from the Business Improvement Order Issued to ChuoAoyama by the Financial Services Agency (FSA)

> As a result of inspecting ChuoAoyama PricewaterhouseCoopers, the firm-wide management to ensure audit quality control was deemed insufficient . . .
>
> Specifically, its [measures for ensuring] compliance with laws/regulations and its implementation of auditors' independence [mandates] were found to be insufficient, and its system [for] training, etc. was deemed partially insufficient.
>
> In addition, its risk assessments at the time of engagement acceptance/continuance, the performance of audit work by each audit team and the documentation/retention of audit working papers were deemed partially insufficient. In terms of internal reviews of audits, although a multi-tiered review system has been implemented, reviews rely on those [provided] by review partners and some are deemed to lack depth. In this context, its internal review system [for identifying problematic] issues of each audit and [for confirming] the appropriateness of the judgments and dispositions [with regard] to such issues were partially insufficient. Its monitoring of the quality control system was deemed partially insufficient, and joint audits were deemed insufficient.
>
> Furthermore, its control system for branch offices was deemed insufficient.
>
> Source: Financial Services Agency (www.fsa.go.jp).

Shortly after the FSA announced that it was suspending ChuoAoyama's operations for two months, the accounting firm's U.S. affiliate, PricewaterhouseCoopers, revealed that it would be creating a new Japanese accounting firm known as Aarata, a name that means "new and fresh" in Japanese. Aarata commenced operations on July 1, 2006, and in the subsequent weeks acquired dozens of ChuoAoyama's former clients, including Sony and Toyota. In addition, nearly one-fourth of ChuoAoyama's employees left that firm to join Aarata.

The Kanebo audit failure prompted the FSA to investigate the audit practices of each of Japan's four large accounting firms. These investigations were carried out by the newly created CPAAOB that had been placed under the authority of the FSA. The stated purpose of the investigations was to "regain public trust in certified public accountants damaged by ChuoAoyama auditors' involvement in Kanebo's falsification of its financial statements."[18] The CPAAOB issued a report on the six-month long investigations in July 2006. That report criticized the operating policies and procedures of the four accounting firms. As a result of the CPAAOB's report, the FSA issued "business improvement orders" to each of the four firms. Exhibit 1 includes an excerpt of the business improvement order issued to ChuoAoyama.

In the aftermath of the Kanebo audit failure, leaders of the Japanese accounting profession spoke out about the need for additional reforms to strengthen the nation's independent audit function. One such individual was Tsuguoki Fujinuma, the chairman and president of the JICPA. Fujinuma issued a public statement in which he compared the Kanebo incident to the Enron debacle in the United States.

> *The Enron affair was not an isolated problem of one accounting firm. To the contrary, it was regarded as a failure of the entire CPA system and provoked a barrage of criticism against audits and auditors in the U.S. public. This affair ultimately led to the passage of the Sarbanes-Oxley Act, legislation imposing severe controls on CPAs.*

18. *Japan Economic Newswire* (online), "FSA to Inspect 4 Biggest Auditing Firms," 25 October 2005.

I urge all JICPA members engaged in audits to make efforts to ensure the public confidence in auditing practices, together with the JICPA itself. As they do so, I further urge them not to regard the Enron affair as a distant or unrelated failure to the accounting system, nor to regard the Kanebo incident as an isolated problem involving only one auditing firm.[19]

Despite such statements and the actions of the FSA and other regulatory authorities in response to the Kanebo affair, many third parties doubted that there would be major changes in Japan's independent audit function. As one skeptic noted, "cultural mores" will likely prove to be "sand in the gears of change."[20]

Questions

1. Research online news services to identify recent developments impacting the accounting and auditing profession in Japan. Briefly summarize these developments in a bullet format.
2. As noted in this case, Japanese companies typically rely more heavily on debt capital than U.S. companies. Explain how this fact may cause the independent audit functions in the two countries to differ.
3. The much higher barriers to enter the public accounting profession in Japan (as compared with other major industrialized countries) has resulted in a relatively small number of CPAs in that nation. Identify and briefly discuss the comparative advantages and disadvantages of high barriers to entry for a given profession.
4. In both Japan and the United States, a small number of accounting firms audit the great majority of large public companies. Identify the advantages and disadvantages of this "market structure" for independent audit services.
5. In both Japan and the United States, external auditors have frequently been accused of failing to maintain a proper degree of independence from their clients. What measures have and should be taken to promote the independence of auditors from their clients?

19. T. Fujinuma, "On the Alleged Fraudulent Accounting at Kanebo," website of Japanese Institute of Certified Public Accountants (www.hp.jicpa.or.jp/), 16 September 2005.

20. Reilly and Morse, "Japan Leans On Auditors."