Corporate Disclosure in Japan

Overview

The Japanese Institute of Certified Public Accountants
2006
(Fifth Edition)
FOREWORD

The auditing and accounting system in Japan has been greatly enhanced over the past few years. The amended Certified Public Accountants Law ("CPA Law") became effective on April 1, 2004, which has strengthened auditor's independence, established the Certified Public Accountants and Auditing Oversight Board ("CPAAOB"), commenced CPAAOB's monitoring of quality control reviews performed by the Japanese Institute of Certified Public Accountants ("JICPA"), launched a reform of the examination system for Certified Public Accountants, and made continuing professional education compulsory which had formerly been operated by the JICPA on a self-regulatory basis.

After consecutive amendments over the past several years, the Commercial Code and other related laws and regulations were totally restructured and integrated into Corporation Law, to become effective May 2006. The objective of these amendments is to modernize the language as well as the provisions in order to reflect recent changes in social and economic circumstances. This revision provides greater flexibility for Japanese corporations with respect to their corporate governance structure. Auditing requirements are stipulated based on the structure selected.

This booklet is the fifth edition of "Corporate Disclosure in Japan – Overview" published by the International Relations Committee of the JICPA in order to furnish both historical and up-to-date information on the outline of the corporate disclosure system in Japan. The new auditing aspects of the amendment to the Corporation Law have been incorporated into this booklet. I am certain that this booklet will assist you in acquiring better understanding of an overview of the current status of corporate disclosure in Japan.

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Chairman and President
The Japanese Institute of Certified Public Accountants

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Chapter I  
Participants in the Disclosure System

1. Corporations

The new Corporation Law of Japan was promulgated on July 26, 2005 and went into effect on May 1, 2006, replacing a portion of the Commercial Code which had set forth regulations on corporations. Under this revision the following forms of corporations are authorized:
(1) Kabushiki-kaisha (joint stock corporation)
(2) Gomei-kaisha, (similar to General Partnership)
(3) Goshi-kaisha (similar to Limited Partnership), and,
(4) Godo-kaisha (similar to Limited Liability Company).
Gomei-kaisha, Goshi-kaisha, and Godo-kaisha have no disclosure requirements under the new Corporation Law. Kabushiki-kaisha or a joint stock corporation whose shareholders' liability is limited to their investments, is the most common form of corporation in Japan and the form most closely related to the disclosure system discussed herein.

The former minimum capital requirement for joint stock corporations under the Commercial Code of Japan, which was set at a minimum of ¥10 million, has been removed under the new Corporation Law.

i) Disclosure Requirements under the New Corporation Law

The principal objective of the disclosure requirements of a joint stock corporation under the new Corporation Law is to protect the interests of both creditors and shareholders.

These flows described below are largely identical to provisions stipulated by the former Commercial Code.

A Kabushiki-kaisha is required to hold a general meeting of the shareholders within three months after the balance sheet date to deliberate on certain corporate matters, including the approval of its financial statements. Typically, the notification of a general meeting of the shareholders must be accompanied by a business report and financial documents including the corporation’s non-consolidated financial statements attested by the corporate statutory auditor or the audit committee, which is an internal organization of a corporation not required to be or composed of certified public accountants. The financial statements are required to be submitted to and approved by the shareholders at the general meeting.

These documents are subsequently mailed to the shareholders in the form of an annual report. In addition, the new Corporation Law stipulates that these documents be maintained at all times at the head office and at branches of the joint stock corporation for inspection by creditors and shareholders and that the condensed balance sheet be published in newspapers or gazettes.

The new Corporation Law has drastically restructured the former regulations set forth in the Commercial Code as well as other related regulations including those in "The Law for Special Exceptions to the Commercial Code Concerning Audits and etc. of Joint Stock Corporations,"
which stipulated external audit requirements. However, the new Corporation Law carries forward certain statutory audit requirements of the Commercial Code and the related regulations. For a large corporation capitalized at ¥500 million or more or whose liabilities are ¥20,000 million or more at the fiscal year end, certain special regulations apply. First, its financial statements and supporting schedules are required to be audited not only by the corporate statutory auditors or its audit committee but also by an independent certified public accountant ("CPA") or an audit corporation. Secondly, after its financial statements have been certified by the corporate statutory auditors or the audit committee and a CPA or an audit corporation, approval of these statements at the annual general meeting of the shareholders is not required as long as the Board of Directors resolves to adopt the financial statements. Furthermore, both the balance sheet and the statement of income must be published in newspapers or on a website.

In addition, large corporations which file their Securities Reports with the Financial Services Agency (the "FSA") are required to prepare consolidated financial documents and disclose these in their annual reports.

ii) Disclosure Requirements under the Securities and Exchange Law ("SEL")

Disclosure requirements under the SEL are aimed to protect the general interests of the investors. Only public corporations are subject to these disclosure requirements.

Disclosure at the Time of Issuing Securities

Corporations which offer their own shares and/or bonds in public offerings are required to file registration statements with the FSA, except when certain conditions are met. If these registration statements are accepted without any amendment order within 15 days of the filing, the statements automatically take effect and the corporations may offer their securities and/or bonds after issuing a prospectus for distribution to the investors.

Typical registration statements describe the method of subscription, the nature of the business engaged in, information on capital expenditures, an outline of the corporate governance structure, an analysis of the corporation's financial position, operating results and cash flows and so forth. They also include comparative consolidated and non-consolidated financial statements and supporting schedules for two consecutive accounting periods audited by a CPA or an audit corporation. The contents of the prospectus are, in principle, the same as those of the registration statements filed with the FSA.

Ongoing Disclosure

Corporations which have offered securities and filed registration statements in the past or whose shares are listed on Japanese stock exchanges (hereinafter referred to as "registered corporations") are required to file Securities Reports on an annual and semiannual basis with the FSA. The contents of a corporation's Securities Report and semiannual Securities Report are usually in its registration statement, which contains additional information.
Corporations which are obligated to submit these reports are also required to submit an updated report to the stock exchanges if they offer securities for subscription overseas, if there is a major change in their shareholders, or if certain other specified events take place in order to ensure timely disclosure.

Further Disclosure of Reports

The reports mentioned above, including the registration statements, are furnished for public perusal at the issuing corporation, at the FSA, and at the stock exchanges on which the corporation's securities are listed. Copies of the reports are also available at government publication centers. An electronic disclosure system for Securities Reports has also been introduced so that any member of the public can gain internet access to such financial information at any time.

Number of Publicly Listed Corporations

Figure 1 below shows the number of publicly listed corporations subject to disclosure requirements under the SEL.

![Pie chart showing the number of listed corporations as of December 31, 2005](image)

**Fig. 1 Number of Listed Corporations as of December 31, 2005**

2. CPAs

i) CPA Qualifications

CPAs, through their own audit practices, are closely related to the system of disclosure. In order to become a CPA, one must pass a series of examinations. The details of the examination system are set forth in the CPA Law.
The examination system consists of two phases. The first phase covers accounting theory including financial accounting and cost accounting, auditing theory, business law, taxation and one of the following four subjects: business administration, economics, civil law and statistics. After three years of training and two years of practical experience as an accounting assistant, a candidate is qualified for the second phase, a final assessment conducted by the Japanese Institute of Certified Public Accountants ("JICPA"). In order to test technical competence, the final assessment includes accounting theory and practice, auditing theory and practice, management theory and practice (including IT issues), taxation theory and practice and the laws and regulations governing the CPA practice and professional ethics.

ii) Individual CPAs and Audit Corporations

The total number of qualified Japanese CPAs was 16,245 as of December 31, 2005 as compared to more than 330,000 CPAs in the United States. It is estimated that more than half of the CPAs in Japan practice auditing. The remaining CPAs are either engaged in tax practices, management advisory services or other areas of public accounting, or are employed by government agencies or public and private enterprises.

In addition to CPAs, there are currently approximately 69,000 licensed tax accountants in Japan.

Prior to 1966, auditing was conducted exclusively by individual CPAs. In 1966, a measure aimed at forming the cooperative organizations of individual CPAs was developed by the national government. As a result, "audit corporations" with unlimited liability were introduced. As audit corporations enjoy a number of advantages which include the availability of professional trained staff and a well-developed system of quality control over audit engagements, their establishment has been encouraged.

Number of CPAs in Japan
Number of junior CPAs in Japan

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Number of audit corporations in Japan

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<tr>
<td>Value</td>
<td>63</td>
<td>110</td>
<td>149</td>
<td>162</td>
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Note 1: The figures in parentheses represent registered foreign CPAs.
Note 2: Audit corporations did not exist before 1967.

Fig. 2. Number of CPAs and Audit Corporations in Japan
iii) The JICPA

The JICPA is a distinctive corporate professional body in Japan, and the only organization permitted to be established under the CPA Law. All CPAs are required to join the JICPA so that the JICPA may effectively guide and supervise its members and maintain close contact with them for the maintenance of a strong and independent organization.

The JICPA has stipulated a code of ethics (the "Code") in order to establish the foundation underlying the integrity of the profession as CPAs and requires their strict adherence to this Code.

In addition, the JICPA, through its various committees and project teams, carries out a wide range of activities from self-regulation to the provision of services to its members. Some of those important activities include the following:
(a) conducting research on and investigation into practices and systems of accounting, auditing and other related professional services in Japan and overseas;
(b) providing guidance on auditing, accounting and other related professional services and submitting comments on various exposure drafts published by other organizations;
(c) providing pre-qualification training courses and programs for continuing professional education;
(d) performing quality control reviews; and
(e) conducting investigative and disciplinary proceedings.

As a part of its international activities, the JICPA has been cooperating as a member of the International Federation of Accountants ("IFAC") and the Confederation of Asian and Pacific Accountants ("CAPA"), and has contributed significantly to international cooperation in the promotion of accounting and auditing practices. The JICPA dispatches its members to several boards or committees of IFAC and contributes to IFAC boards or committees engaged in standard-setting processes by responding to invitations to comment on proposed standards and guidelines. In order to ensure compliance with the Statements of Membership Obligations set forth by IFAC, the JICPA has reflected pronouncements such as the Code of Ethics and the International Standards on Auditing ("ISA") in its own standard-setting.

3. Accounting and Auditing Standards in Japan

The process of setting accounting and auditing standards, previously driven by the Ministry of Finance ("MOF") and the FSA after the reorganization of government ministries and agencies, has been gradually changing.

With respect to the standard setting for auditing, even though basic standards are set by the Business Accounting Council ("BAC"), an advisory body established within the FSA, the role of the JICPA in setting standards has become increasingly important because of continued international pressure and the forces encouraging deregulation in Japan. In 1992, the JICPA established the Auditing Standards Committee. Since then the Committee has set out the Implementation Guidance referred to as Auditing Standards Committee Statements as a guide for
audit practice. The auditing standards established by the BAC and the Implementation Guidance by the JICPA, taken together, are deemed to comprise generally accepted auditing standards ("GAAS") in Japan.

The Internal Control Committee, newly created by a reorganization of the BAC in 2005, has published the proposed Fundamental Framework of Internal Control, Management's Assessment and Reporting on Internal Control over Financial Reporting, and Standards on the Auditing of Internal Control over Financial Reporting. These pronouncements were issued to improve the reliability of financial statements of listed corporations after a careful examination of the U.S. experience in implementing a similar regulating system.

In terms of global standard-setting for auditing, the International Auditing and Assurance Standards Board ("IAASB") functions as an independent standard-setting body under the auspices of the IFAC. Members of the BAC and the JICPA's Auditing Standards Committee participate in the IAASB in order to strengthen global auditing and assurance standard-setting initiatives. In addition, the statements issued by the IAASB are incorporated into Japanese auditing standards and into the committee statements issued to strengthen the audit profession in Japan through globalization.

As for the standard setting for accounting, the Financial Accounting Standards Foundation ("FASF") was established in 2001, and the Accounting Standards Board of Japan ("ASBJ") was subsequently organized under the auspices of the FASF as an independent, private-sector entity to develop accounting standards in Japan. Since its inception, the ASBJ has issued many accounting standards and guidelines. In addition, in January 2005, it announced the launch of a joint project with the International Accounting Standards Board ("IASB") aimed at achieving convergence between Japanese and international accounting standards.

4. Regulatory Agencies

The FSA is responsible for disclosures required under the SEL and the Ministry of Justice is in charge of corporate disclosure under the Corporation Law. The difference between the two sets of regulations relates to the fact that the SEL covers public corporations and is thus intended to protect investors in general whereas the Corporation Law covers all corporations.

With respect to registration statements, Securities Reports, semiannual Securities Reports and other relevant reports, officials of the Securities and Exchange Surveillance Commission established within the FSA carefully review that the filings comply fully with the mandatory requirements. They also review for the existence of any misstatement and examine the reasonableness of the CPA's opinion. If necessary, they may order amendments, or suspension of the sale of shares or of a share offering (in the case of registration statements).

5. Stock Exchanges

From the viewpoint of ensuring fair pricing and the smooth distribution of securities, a rigorous disclosure system is very important to Japanese stock exchanges.
i) Listing and Delisting Criteria

There were eight stock exchanges throughout the country in 1998, but the number was reduced to six when stock exchanges were merged into the Tokyo or Osaka Stock Exchanges. All have their own listing criteria, but the details of these criteria are similar.

In the case of listing on the Tokyo Stock Exchange: (a) the number of shares to be listed, number of shares to be sold to the public, diversification and number of shareholders before and after sale, agent for share handling, classes and transferability of shares and etc. are checked to ensure smooth distribution of securities, and (b) information such as the amount of net assets, net income and market capitalization, and number of years since the establishment of the listing corporation are also examined to determine whether or not it has a stable financial base.

With respect to the Securities Report for listing (similar to, but more detailed than, the Securities Report generally used under the SEL), the corporation's consolidated and non-consolidated financial statements for the two most recent years and the semiannual financial statements for the prior year must be attached to the report. These financial statements must be audited by CPAs or audit corporations and have an unqualified opinion for the last year.

Upon receiving a listing application, the stock exchange is required to see whether the applying corporation meets the formal requirements mentioned above, to ask the necessary questions to the corporation itself and to its CPAs or an audit corporation, and to execute other procedures, including a field survey, before the listing can be approved.

With respect to delisting, the shares of the corporations may be delisted from a stock exchange under one or more of the following situations, among others:

- Continuous capital deficiency for a few years
- The value of market capitalization is less than the minimum requirement
- Reorganization or liquidation
- Material misstatement in its Securities Report
- An adverse opinion or disclaimer of opinion on the financial statements
- Number of shares or shareholders is/are less than the minimum requirement
- Number of transactions is less than the minimum requirement

ii) Timely Disclosure

In the event that any important fact arises which may affect the investors' decision-making regarding a listed corporation, the stock exchanges generally require the corporation to present the relevant information fairly to the investors without delay. If such disclosure is not made on a timely basis, the stock exchanges may temporarily suspend trading of the securities of the listed corporation until it properly discloses such information.
iii) The Securities Dealers Association of Japan ("SDAJ") and the JASDAQ market

There was a market for so-called over-the-counter shares, which should be registered with the SDAJ instead of being listed on a stock exchange.

The number of registered corporations on the over-the-counter market was low until the 1970's. However, the registration standards were amended in 1983 due to an increase in the demand for expansion of vital business. The revised standards relaxed the restrictions on registration on the over-the-counter market and offerings and subscriptions of shares and bonds to the public became more attractive. There was a large increase in the number of corporations registered on the over-the-counter market from 196 in 1988, to 832 in 1997.

In 2001, the SDAJ transferred its management of the over-the-counter market to the Jasdaq, Inc. The Jasdaq obtained a stock exchange license in December 2004 and changed its name to Jasdaq Securities Exchange, Inc.

iv) Stock Exchanges and Number of Listed Corporations

The trading volume and the number of listed corporations on each stock exchange vary considerably with transactions being much more numerous on the Tokyo, Osaka and Nagoya Stock Exchanges.

Figure 1 shows the number of corporations listed on exchanges as of December 31, 2005.

6. Securities Houses and Underwriters

Securities houses acting as dealers in securities and brokerage firms are the typical users of information disclosed by corporations that issue securities. On the other hand, securities houses as underwriters of securities assume part of the responsibility for such information because they offer securities for subscription and purchase. Articles 17 and 21 of the SEL specify the civil liabilities of securities houses as distributors of a prospectus and underwriters of securities, respectively.

In the event of loss to an investor arising from alleged reliance on any false statement in a prospectus or registration statement, the investor is entitled to claim damages from the underwriters and others involved. In order to avoid liability for compensation, the underwriters would be required to prove that there was no willful negligence on their part and that due care was exercised regarding the accuracy of the contents of the prospectus or registration statement.

With respect to the financial statements audited by CPAs or an audit corporation which are included in a prospectus, securities houses are released from the provision citing "due care" but there are no exemption clauses for false statements made in the prospectus as a whole. For this reason, the underwriters, who act concurrently as distributors of a prospectus, undertake a thorough review of its financial statements.

7. Securities Analysts
Financial and securities analysis in Japan has thus far been conducted chiefly by financial institutions, especially by the research or underwriting departments of securities houses.

Institutional investors (e.g. life insurance corporations, pension funds, investment trusts and so forth) have securities analysts within their organizations who are responsible for portfolio management in consultation with the securities houses.

Investment counseling to institutional and general investors commenced in the 1960's, as a relatively new profession in Japan. Today, there are hundreds of firms offering investment advice.

Public interest in securities analysis is also increasing. In the past 40 years, institutional investors and securities houses have trained their own people as professional analysts of securities. An examination system for qualification as a securities analyst was inaugurated by the Securities Analysts Association in 1979. There are presently a number of qualified individual members and it is expected that the profession of securities analyst in Japan will continue to grow in the future.
Chapter II Reporting Standards and Practices

1. General

Two legal codes govern the preparation of financial statements in Japan, the Corporation Law and the SEL.

The form and content of the financial statements required under the Corporation Law are dictated by the Cabinet Office Ordinance, formerly known as "Regulations Concerning the Balance Sheet, Income Statement, Business Report and Supporting Schedules of Joint Stock Corporations." The regulations were first promulgated in 1963 as legally binding standards of accounting and reporting to be applied to all joint stock corporations incorporated and operating in Japan.

With the establishment of the new Corporation Law, a Ministerial Ordinance entitled "Regulations on Corporate Accounting" has replaced the Cabinet Office Ordinance. A Ministerial Ordinance is issued by, and may be amended by the Ministry of Justice.

The standards of accounting and reporting to be followed under the SEL by corporations whose debt and equity securities are publicly traded or sold are regulated by "Regulations Concerning the Terminology, Forms and Preparation Methods of Financial Statements," which were first promulgated in 1963 by the Ministry of Finance.

Although there are certain differences in reporting under these two sets of regulations, over the years they have converged following a series of revisions.

2. Reporting under the Corporation Law

i) Statutory Financial Documents

The underlying objective of financial documents prepared in accordance with the Corporation Law is to protect creditors’ and shareholders’ interests. Accordingly, disclosures relating to the availability of retained earnings for the distribution of dividends and to the creditworthiness and earning power of the reporting entity are of prime importance. Emphasis is placed on presenting the financial position and results of operations of a single entity for a single period in accordance with the Corporation Law and with the entity's articles of incorporation.

The financial documents prepared and submitted by a corporation to its annual general meeting of the shareholders (to be held within three months after the year end) are as follows:

- Balance sheet
- Statement of income
- Statement of changes in net assets
- Notes to non-consolidated financial statements
Corporations must also disclose the business report in addition to the financial documents described above.

From the fiscal years ending after March 31, 2004, corporations which are defined as a large corporation under the Corporation Law and which file their financial statements with the FSA are also required to prepare a consolidated balance sheet and a consolidated income statement under the Corporation Law.

ii) Supporting Schedules

The Corporation Law requires that corporations prepare certain supporting schedules to supplement the financial documents and business report.

3. Reporting under the Japanese SEL

Since the purpose of reporting under the Japanese SEL is to ensure adequate and appropriate disclosures for the protection of general investors, the financial sections of the annual Securities Report and the securities registration statement filed with the FSA are presented in more detail than those required under the Corporation Law. Although a balance sheet and income statement are also required under the SEL as required under the Corporation Law, the terminology, form and content of these financial statements and supporting schedules are defined in more detail. Under the financial regulations of the SEL, a cash flow statement is also a component of the basic financial statements.
Chapter III  Accounting Principles and Practices

1. General

Accounting principles and practices in Japan have evolved through general usage and practice over a period of time and have been codified into a series of promulgations and related amendments by the BAC. Accounting standards or principles for business enterprises issued by the BAC have been regarded as generally accepted accounting principles in Japan.

From the so-called "Financial Accounting Big-Bang" since 1996, accounting standards have been revised and developed in order to conform with the globalization and international harmonization of accounting standards. The following accounting standards have been recently implemented:

Accounting Standards for Lease Transactions (issued in June 1993)
Amendment for Accounting Standards for Foreign Currency Transactions (May 1995)
Amendment for Accounting Standards for Consolidated Financial Statements (June 1997)
Accounting Standards for Preparing Consolidated Statement of Cash Flows (March 1998)
Accounting Standards for Preparing Interim Consolidated Financial Statements (March 1998)
Accounting Standards for Retirement Benefits (June 1998)
Accounting Standards for Tax Effect Accounting (October 1998)
Accounting Standards for Financial Instruments (January 1999)
Accounting Standards for Impairment of Assets (August 2002)
Accounting Standards for Business Combinations (October 2003)

In 2001, the FASF was established and the ASBJ was organized as an independent, private-sector entity to develop accounting standards in Japan. Since then, the ASBJ has issued a number of accounting standards and implementation guidance, which also comprise generally accepted accounting principles in Japan.

In addition to the standards and implementation guidance, the Working Group of the ASBJ published a discussion paper entitled "The Conceptual Framework of Financial Reporting" in September 2004. This discussion paper is expected to serve as a basis for developing future accounting standards in Japan.

In January 2005, the ASBJ announced the launch of a joint project with the IASB to achieve convergence between their accounting standards. The first meeting was held in Tokyo in March 2005 to determine which topics should be addressed in the first phase. The IASB and the ASBJ reached an agreement to deliberate the following five areas:
- Measurement of Inventories (International Accounting Standard ("IAS") 2)
- Segment Reporting (IAS 14)
- Related Party Disclosures (IAS 24)
- Unification of Accounting Policies Applied to Foreign Subsidiaries (IAS 27)
- Investment Property (IAS 40)
At the third meeting held in March 2006, the following three items were added to the convergence project:

- Asset Retirement Obligation (International Financial Reporting Standard ("IFRS") 5)
- Construction Contracts (IAS 11)
- Disclosure of Financial Instruments at Fair Value (IAS 32)

With respect to accounting for small and medium-sized entities, there were three proposals of accounting guidelines in Japan published respectively by the Small and Medium Enterprise ("SME") Agency (a government agency promoting SMEs), the National Federation of Tax Practitioners’ Associations and the JICPA in 2002 and 2003. Although the concept of the fair presentation of financial statements is required irrelevant to the size of the entities, current generally accepted accounting principles are predominantly designed to be used by public corporations and are, in many cases, too complicated for small and medium-sized corporations to apply. Therefore, demands for practical guidance in applying these accounting standards to SMEs have increased over the years and accordingly these three organizations published their own guidelines from their own standpoint.

In March 2005, the JICPA, the Federation of Tax Practitioners’ Associations, the Japan Chamber of Commerce and Industry, and the ASBJ established a joint committee to work toward the integration of their three guidelines for SMEs. The new guidelines address the simplification of recognition and measurement in certain areas as well as presentation and disclosure. This new integrated guideline was issued in August 2005 after intensive deliberation.

2. Major Accounting Principles and Practices

As described above, Japanese accounting standards have largely been brought in line with other internationally recognized standards. However, there are certain areas where significant differences still exist. The following are examples of such items where generally accepted accounting principles ("GAAP") in Japan require a different treatment from IFRS.

i) Uniformity of Accounting Policies
Under Japanese GAAP, uniform accounting policies are required to be applied for like transactions and events occurring under similar circumstances. However, it was permissible to use financial statements prepared in accordance with the local GAAP of foreign subsidiaries, unless a significant difference in accounting policies would lead to unreasonable consequences.

Under IAS 27, unification of accounting standards for consolidated accounts is required. Under IAS 28, uniformity of accounting policies for associates is required as well.

In November 2005, the ASBJ issued an exposure draft Practical Issues Task Forces Reports proposing to amend the existing exemptions available for foreign subsidiaries under Japanese GAAP. The exposure draft still allows usage of different accounting standards for foreign subsidiaries, but limits this to IFRS and US GAAP. It also requires certain adjustments to be made when a difference in accounting policies would have a significant effect on net consolidated profit or loss. This Practical Issues Task Forces Report No. 18 was issued on May 17, 2006.

ii) Scope of Consolidation
Under Japanese GAAP, Special Purpose Entities ("SPEs") established solely for the purpose of transfer of financial assets are generally considered to be pass-through entities. Therefore, such SPEs are deemed not to be under the control of the reporting entity and are excluded from consolidation. IAS 27 and SIC-12 require SPEs to be consolidated when the substance of the relationship between an entity and an SPE indicates that the entity controls the SPE. It should also be noted that under Japanese GAAP, when assessing existence of control, potential voting rights are not taken into account. IAS 27 requires potential voting rights to be considered when determining whether or not there is control.

iii) Business Combinations
Japanese GAAP requires application of the pooling of interest method for certain business combinations. In addition, goodwill, in general, should be amortized by applying the straight-line method over periods not exceeding 20 years. Under IFRS 3, the purchase method must be applied for all business combinations within its scope. In addition, goodwill may not be amortized and impairment tests are required to be carried out annually in accordance with IAS 36.

iv) Inventories
Under Japanese GAAP, the cost method is allowed as an alternative to the lower of cost or market method. Accounting rules in relation to inventories, however, are currently still under review. Under IAS 2, inventories must be stated at the lower of their historical cost or net realizable value.

v) Impairment of Assets
Under Japanese GAAP, when amounts of undiscounted future cash flows of non-current assets are less than their carrying amounts, the difference between the carrying amount and the recoverable amount is recognized as an impairment loss. The recoverable amount is the higher of an asset's fair value less costs to sell (net selling price) and its value in use (the discounted present value of estimated future cash flows). The reversal of an impairment loss recorded on non-current assets is prohibited. Under IAS 36, an asset is deemed to be impaired when its carrying amount exceeds its recoverable amount. If the amount of a previously recognized impairment on the asset decreases, the impairment loss must be reversed through net profit or loss.

vi) Capitalization of Development Costs
Under Japanese GAAP, costs incurred during the development phase must be expensed when incurred. Under IAS 38, an intangible asset arising from development must be recognized if it meets certain conditions. The ASBJ has indicated they will carry out a preliminary study project on accounting for intangibles as part of the convergence process.

vii) Construction Contracts
Japanese GAAP allows the usage of both the percentage-of-completion method and the completed construction method to account for construction contracts. Under IAS 11, revenue and costs associated with construction contracts should be recognized by
applying the percentage-of-completion method when the outcome of the contracts can be estimated reliably.

As described above, this topic has been added to the agenda of the IASB-ASBJ convergence project.

viii) Employee Benefits
There are various differences in the details between Japanese GAAP and IAS 19 with regard to employee benefits, but one of these is that Japanese GAAP does not allow the application of the so-called "corridor approach" for defined benefit plans as permitted by IAS 19.

ix) Leases
In principle, Japanese GAAP requires finance lease transactions to be accounted for in the same manner as normal sales and purchase transactions. Lessees of finance lease transactions should capitalize the leased assets and depreciate them over the economic useful lives as would be done upon the acquisition of tangible fixed assets. Operating leases (lease transactions other than finance leases) are accounted for as rental transactions; that is, annual lease payments are charged directly to income as an expense.

However, finance lease under which the ownership of the leased assets is not transferred to the lessee can be accounted for as operating leases. In such cases, certain financial information must be disclosed in the footnotes. This option does not exist in IAS 17 and is also under review by the ASBJ.
Chapter IV  Auditing

1. Introduction

Recent revisions to Japanese auditing standards and governing regulations have made the Japanese audit regime equivalent to those considered to be of an international stature. Japanese Auditing Standards and Implementation Guidance have become substantially equivalent to that of the ISA, implementing a "new risk-based approach" to the audit.

As part of international initiatives to strengthen auditing regimes, a revised CPA Law went into effect in April 2004. This revision includes a prohibition against providing certain non-audit services contemporaneously with audit services and a requirement for audit partner rotation in order to strengthen auditor independence. The revised CPA Law also mandates establishment of the CPA and Auditing Oversight Board ("CPAAOB") within the FSA so as to enhance the function of oversight of CPAs and JICPA. The Executive Bureau of the CPAAOB examines disciplinary actions against CPAs and audit corporations and conducts CPAs Examinations, monitors and reviews the quality control reviews of the internal control and examination system of audit corporations by the JICPA. It also inspects CPAs, audit corporations and the JICPA to ensure the effectiveness of this monitoring. The CPAAOB may issue recommendations to the Commissioner of the FSA for disciplinary action or other measures.

2. Outline of Audit Practice in Japan

Audits conducted by CPAs or audit corporations are broadly classified into statutory and voluntary audits. Statutory audits are required mainly under the SEL and the Corporation Law. Financial statements of public corporations must be audited by independent CPAs or audit corporations under the SEL. And the Corporation Law requires certain corporations to be audited by independent CPAs regarding its financial documents sent together with the invitation letter to the annual general meeting of the shareholders.

The Corporation Law also provides that the corporate statutory auditor or the audit committee has a duty to examine the financial documents prior to the annual general shareholders' meeting. The corporate statutory auditor or equivalent is also responsible for monitoring the activities of the directors as a part of corporate governance.

Some corporations request voluntary audits in order to obtain independent assurance regarding the accuracy and reliability of their financial statements in order to strengthen management’s accountability or to facilitate financing activities.

(1) Financial Statement Audits under the SEL
Corporations must file security registration statements with the FSA in case of the issuance and/or sale of its securities and public corporations must file annual Securities Reports with the FSA. The security registration statements and the annual Securities Reports include both audited consolidated financial statements and audited non-consolidated financial statements. Public corporations are also
required to file semiannual reports which include semiannual consolidated and non-consolidated financial statements, both of which are subject to "semiannual audit."

i) Disclosure Requirements under the SEL
Under the SEL, corporations which offer securities to the public or whose outstanding securities are traded publicly must file financial statements with the FSA as part of their security registration statements, annual Securities Reports or semiannual Securities Reports.

Generally, the financial statements are prepared on both a consolidated and a non-consolidated basis and consist of the following:
- Balance sheet
- Statement of income
- Statement of changes in net assets
- Statement of cash flows (non-consolidated basis is not required if a consolidated statement is prepared)
- Supporting schedules

The main objectives of the accounting and disclosure system under the SEL are:
(i) To provide information to investors for decision-making; and
(ii) To facilitate fair and smooth securities transactions.

ii) Audit Requirements under the SEL
Filed financial statements, other than semiannual financial statements, must be audited by an independent CPA in accordance with Japanese GAAS. The SEL also requires audits of the financial statements of certain companies whose securities are not publicly traded. The independent auditor's report expresses an opinion as to the fairness of the presentation of the corporation's results of operations, cash flows and financial position in accordance with Japanese GAAP. The independence of the auditor, together with the independent auditor's reporting requirements, is established under the Cabinet Office Ordinance entitled "Ordinance Concerning Audit Certification of Financial Statements".

iii) "Semiannual Audits"
Under the SEL, semiannual financial statements are subject to certain assurance engagements, which is called a "semiannual audit," the purpose of which is to express a conclusion that the semiannual financial statements provide useful financial information, prepared in compliance with the "Accounting Standards for Preparing Interim Consolidated Financial Statements." In conducting the "semiannual audit," the auditor follows Semi-Annual Auditing Standards, which provides for less extensive procedures than annual audits, but more than reviews.

iv) Review of Quarterly Balance Sheets and Income Statements
Currently, quarterly balance sheets and income statements for the first and third quarters, which are prepared by listed companies for certain stock exchanges in Japan, are subject to a review by independent auditors under the requirements of those stock exchanges. The demand for quarterly reviews is expected to grow along with the increasing demand for quarterly disclosure. Review standards for quarterly financial information are currently under deliberation by the BAC.

v) Auditor's Reports
The auditor's report includes the following basic elements:
(a) Title;
(b) Addressee;
In the scope paragraph of the auditor's report, the financial statements being examined must be identified and a statement must indicate that the examination was made in accordance with Japanese GAAS.

The auditor is required to state his or her opinion as to whether the financial statements present fairly the financial position and results of operations and cash flows in conformity with accounting principles and practices generally accepted in Japan. Possible opinions include an unqualified opinion, a qualified opinion, a disclaimer of opinion and an adverse opinion.

It should also be noted that if there are any specific matters which are considered necessary in order for the users of the financial statements to be fully informed, such as changes in accounting policy with reasonable justification, material contingent liabilities, material subsequent events, or matters regarding a going concern assumption, the CPA or audit corporation must disclose them in a footnote to the audit report.

(2) Audits under the Corporation Law

The main objectives of the accounting and disclosure system under the Corporation Law are:

(i) To protect creditors and current shareholders;

(ii) To compute the distributable earnings of the business enterprise; and

(iii) To evaluate management’s performance of its stewardship function.

i) Disclosure Requirements under the Corporation Law

Corporations which have a Board of Directors ("Torishimariyaku-kai Secchi-kaisha") must send out their shareholders business reports and financial documents along with an invitation letter to the general shareholders' meeting. The financial documents consist of the balance sheet, income statement, statement of changes in net assets and the notes to financial statements. And financial documents and its supporting documents of the corporations which appoint independent auditors
("Kaikei-kansanin Secchi-kaisha") have to be audited by independent auditor. Corporations are not required semiannual financial reporting under the Corporation Law and the consolidated financial documents of corporations whose consolidated financial statements are filed with the FSA are also subject to an audit under the Corporation Law.

The corporations which appoint independent auditors ("Kaikei-kansanin Secchi-kaisha") may prepare consolidated financial documents. And large corporations whose financial statements are filed with the FSA must prepare consolidated financial document.

ii) Design and Audit of Corporate Governance Structures
The Corporation Law allows wide discretion on design of corporate governance structure and stipulates mandatory financial audit in accordance with this. Certain joint stock corporations, referred to as "Kaikei-kansanin Secchi-kaisha," must appoint independent auditors and are subject to their audit.

- Large corporations: Capital stock of ¥500 million or more, or total liabilities of ¥20 billion or more, as of the latest fiscal year-end.
- Corporation which has a Nomination committee, an Audit committee and a Remuneration committee ("Iinkai Secchi-kaisha").
- Other corporations which appoints independent auditor on a voluntary basis.

Corporate statutory auditors are required to perform financial and operational audits. In respect of corporations which restrict transfer of shares by articles of incorporation, shareholders may also limit the responsibility of corporate statutory auditor to financial audit in the same document.

iii) Auditor's Reports
The Corporation Law and the related Ministerial Ordinance specify the matters required to be stated in the auditor's report. They are basically the same as those required under the SEL.

3. Regulatory Framework of the CPA Profession in Japan

(1) The CPA Law
The CPA Law provides the basic framework for the audit profession in Japan. It sets forth the scope of services to be provided by CPAs, the establishment of the national CPA examination, requirements for CPA qualification, establishment of audit corporations, duties and responsibilities of CPAs, roles and organization of the JICPA, roles of the regulatory authority, and the disciplinary
and criminal sanctions applicable to CPAs. The CPA Law grants the CPAAOB, an arm of FSA, the authority to oversee CPAs and the JICPA.

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

All qualified CPAs are registered with the JICPA as this registration denotes their qualification as CPAs in Japan. The JICPA are to provide guidance to, communicate with, and supervise the members in order to uphold professional standards and improve and advance the profession.

Members are legally required to comply with the JICPA Constitution. The Constitution includes provisions on members' obligations to observe the Code of Ethics and the resolutions of various committees, including the Auditing Standards, Quality Control Review, and Audit Practice and Review Committees. Changes in the JICPA Constitution must be approved by the FSA. Members of the JICPA are subject to the reporting requirements, direction, and disciplinary action of the JICPA. In addition, CPAs and audit corporations which perform audits for public corporations and certain private corporations must be reviewed periodically by quality control reviewers from the JICPA.
Chronological Table Outlining Corporate Disclosure in Japan

1947  * The SEL went into effect.
      * The Anti-monopoly Law went into effect.

1948  * The CPA Law went into effect.
      * The Investigation Committee on Enterprise Financial Accounting System of the Economic Stabilization Board (predecessor of the Business Accounting Deliberation Council) was established.

1949  * The Tokyo, Osaka and Nagoya Stock Exchanges were opened.
      * The first CPA examination was held.
      * "Financial Accounting Standards for Business Enterprises" was issued.
      * The JICPA was established.

1950  * "Regulations Concerning the Terminology, Forms and Preparation Methods of Financial Statements" was issued.
      * "Auditing Standards" and "Working Rules for Fieldwork" were issued.

1951  * Audits by CPAs under the Securities and Exchange Law began.
      * "The Licensed Tax Practitioners Law" went into effect.

1952  * "The Law for the Reorganization and Rehabilitation of Joint Stock Corporations" went into effect.

1953  * The JICPA became an incorporated association under the Civil Code.

1956  * "Working Rules for Reporting" was issued.

1958  * Debentures by private Japanese enterprises were issued outside Japan for the first time since World War II.

1961  * The second section of the stock exchange was opened.
      * American Depositary Receipts (ADRs) were issued by private Japanese enterprises in New York.

1962  * "The Security Analysts Association of Japan" was established.
      * "Cost Accounting Standards" was issued.

1963  * Financial statements of corporations whose shares were traded over-the-counter became subject to audit.
      * "Regulations concerning the Balance Sheet, Income Statement and Supporting Schedules of Joint Stock Corporations" was issued.
1966 * The JICPA was reorganized as a special legal entity and all CPAs were required to join as members.

1967 * Capital liberalization began.
   * The first audit corporation permitted under the special law was established.

1969 * European Depositary Receipts (EDRs) were issued in London.

1970 * Stock exchanges began to delist shares of corporations which had issued fraudulent financial statements.
   * Shares of a Japanese enterprise were listed on the New York Stock Exchange for the first time.

1971 * Following President Nixon’s announcement regarding the U.S. dollar policy, a significant decline in stock prices took place.

1973 * Foreign shares were listed on the Tokyo Stock Exchange for the first time.

1974 * Audits by CPAs under the Commercial Code began.

1975 * The number of CPAs in practice exceeded 5,000.
   * "Financial Accounting Standard on Consolidated Financial Statements" was issued.

1976 * Semiannual reporting went into effect.
   * "Regulations Concerning the Terminology, Forms and Preparation Methods of Consolidated Financial Statements" was issued.

1977 * "Opinion on Interim Financial Statements included in Semiannual Reports" was issued.
   * Audits of interim financial statements by CPAs began.
   * Preparation and filing of consolidated financial statements went into effect.
   * A requirement for the timely disclosure of events which may have material effect on the market price of listed shares went into effect.

1979 * "Accounting Standards for Foreign Currency Transactions" was issued.

1981 * Disclosure and audit requirements were expanded and strengthened following a revision of the Commercial Code.
   * The meeting of International Accounting Standards Committee was held in Tokyo.


1983 * "Guidelines for Equity Method Accounting" was issued.
1985  * "Auditing Standards for EDP Systems" was issued.
     * "Accounting Standards for Labor Unions" was issued.

1986  * "Auditing Manual for Private Schools" was issued.

1987  * The 13th World Congress of Accountants was held in Tokyo.

1988  * The Securities and Exchange Law was amended to require segment information to be included in the consolidated financial statements.

1990  * "Disclosure of Segment Information" went into effect.
     * "Disclosure of Market Prices of Marketable Securities, Futures, Options" went into effect.

1991  * Consolidated financial statements were required to be included in annual Securities Reports.
     * "Disclosure of Related Parties Transactions" went into effect.

1993  * The definition of marketable securities under the Securities and Exchange Law was changed to include commercial paper, beneficial certificates of mortgage securities notes trust.
     * Segment Information became subject to audit.
     * "Opinion concerning Accounting Standards for Lease Transactions" was issued.

1994  * Provisions regarding the scope of consolidation, application of the materiality concept in the determination of the scope of consolidation, and application of the equity method were withdrawn.
     * "Disclosure of Forward Exchange Contracts" went into effect.

1995  * "Disclosure of Diluted Earnings per Share" went into effect.
     * "Amendment to Accounting Standards for Foreign Currency Transactions" was issued.
     * "Accounting for Disclosure of Segment Information" was issued.

1997  * "Amendment to Accounting Standards for Foreign Currency Transactions" went into effect.
     * "Disclosures of Derivative Transactions" went into effect.
     * "Opinion concerning Amendment to Accounting Standards for Consolidated Financial Statements" was issued.

1998  * "Accounting Standards for Preparing Consolidated Statements of Cash Flows" was issued.
     * "Accounting Standards for Preparing Interim Consolidated Financial Statements" was
issued.
* "Accounting Standards for Research and Development Costs" was issued.
* "Accounting Standards for Retirement Benefits" was issued.
* "Accounting Standards for Tax Effect Accounting" was issued.
* Quality Control Review was introduced by the JICPA.
* The Continuing Professional Education Program was introduced by the JICPA.

1999  * "Accounting Standards for Deferred Income Taxes" went into effect.
* "Accounting Standards for Financial Instruments" was issued.
* "Amendment to Accounting Standards for Foreign Currency Transactions" was issued.

2000  * The Code of Ethics was amended.

2001  * The FASF was established and the ASBJ was organized under the auspices of the FASF.

2002  * "Auditing Standards and Related Rules" was drastically amended.
* The ASBJ issued its first accounting standard: "Accounting Standards for Repurchased Stock"
* "Accounting Standards for the Impairment of Assets" was issued.
* The second accounting standard "Accounting Standards for the Computation of Earnings per Share" was published by the ASBJ.

2003  * The CPA Law was drastically amended to strengthen auditors' independence and auditor oversight.
* "Accounting Standards for Business Combinations" was issued by the BAC. The BAC completed its role as an accounting standards setter.

2004  * Amended CPA Law went into effect, except for amendments to the qualifying examination system, which went into effect in 2006.
* The CPA Investigation and Examination Board was reorganized into the Certified Public Accountants and Auditing Oversight Board under an amendment to the CPA Law.
* Discussion paper entitled "The Conceptual Frameworks of Financial Reporting" was issued by the Working Group of the ASBJ.

2005  * The Commercial Code and other related laws and regulations were reorganized into the Corporation Law.

2006  * Amendments to the qualifying examination system of the CPA Law went into effect.
* The Corporation Law went into effect.
* The bills for legislat ing the Financial Instruments and Exchange Law were presented to the Diet.