Accounting Profession in Japan; Professional Accounting in Foreign Country Series

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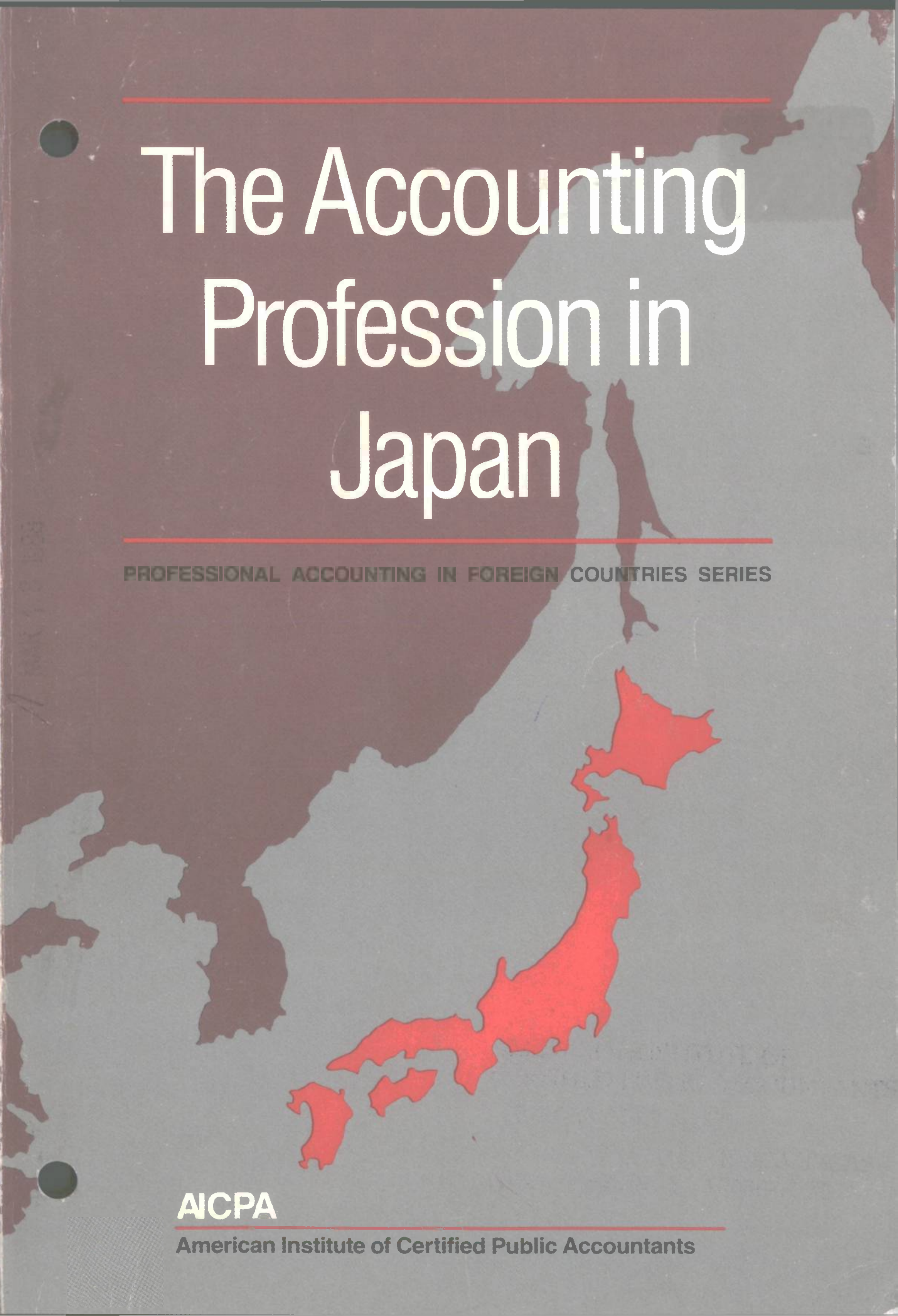
Susan Sgromo

The Accounting Profession in Japan

PROFESSIONAL ACCOUNTING IN FOREIGN COUNTRIES SERIES



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American Institute of Certified Public Accountants

The Accounting Profession in Japan
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Prepared by

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Series Editor

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NOTICE TO READERS

The Professional Accounting in Foreign Countries series is designed to be educational and used as reference material for the members of the Institute and others interested in the subject. It is not intended to establish standards.

The International Practice Committee gratefully acknowledges the contributions made to the development of this series by former committee chairman Harvey D. Moskowitz; former committee members Dale D. Baker, R. Harry Beattie, J. Stanley Blumin, Campbell E. Corfe, Perry D. Harbour, W. Edward Hastings, Konrad W. Kubin, Walter F. O'Connor, W.C. Brian Peoples, Bruce D. Robertson, Martin Rotheim, and Anthony L. Smith; and former staff aide James F. Flynn. The committee would also like to acknowledge the fine editorial efforts of Carrie Vaccaro and Gene Smith and the production work of Robert DiCorcia, David Chipps and Lisa Schmelzer.

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Preface

This booklet is one of a series on professional accounting in foreign countries. The material is current as of September 1987. Changes after this date in the standards of either the United States or Japan may alter the comparisons detailed in this publication.

Included are descriptions of the accounting profession, auditing standards, and accounting principles in Japan. The booklet also presents brief descriptions of the various forms of business organizations, taxes, and requirements for stock exchange listings and securities offerings. Checklists comparing Japanese auditing standards and accounting principles with those generally accepted in the United States are appendixes to the text.

This booklet is not intended to be a comprehensive discussion of auditing standards and accounting principles in Japan but is designed instead to focus primarily on differences with those of the United States.

John Graves
Director
Technical Information Division

Contents

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The Accounting Profession

REQUIREMENTS FOR ENTRY INTO THE PROFESSION

Domestic Functions and Licensing Requirements

1. Two types of accounting professionals are authorized in Japan: "Tax Practitioner" and "Certified Public Accountant." *Tax Practitioner* may be used only by members of the Japan Association of Tax Practitioners (herewith, "the Association") and *Certified Public Accountant* ("CPA") by members of the Japanese Institute of Certified Public Accountants ("JICPA" or "the Institute"). Tax practitioners perform professional services that include the preparation of tax returns and consultation relating to tax matters for business enterprises and individuals. CPAs examine and report on the financial statements of a third party for a consideration. The Association and the Institute admit a new member who has passed the required examination(s) or has the required qualifications and has not been legally restricted by his or her acts. In addition, both the Association and the Institute control professional conduct of their members.

2. A *Kabushiki Kaisha* (limited liability stock corporation or *"KK"*) with a stated capital of yen 500 million or more or total liabilities of yen 20 billion or more (a "large-scale" corporation) is required by the Commercial Code to appoint an independent auditor. The Securities Transactions Law also requires that the audits of companies listed on Japanese stock exchanges and unlisted companies, which have issued new shares or bonds in the amount of yen 100 million or more to the public, file with

the Ministry of Finance ("MOF") annual and semiannual reports, which include financial statements with audit reports signed by independent auditors. Such audit can only be performed by a CPA, a foreign CPA (see paragraph 4 for a discussion of "Foreign Reciprocity") or an audit corporation. An audit corporation can be established by five or more CPAs or foreign CPAs as unlimited liability members of the corporation (collectively referred to hereinafter as CPA or CPAs) or both groups.

3. Although CPAs are prohibited to perform tax services for their audit clients, there is no specific restriction on performing management advisory work for any client.

Foreign Reciprocity

4. Only the tax practitioners and the CPAs who have been qualified in Japan are permitted to perform professional services. Persons with overseas qualifications are permitted to register as a *foreign CPA* after passing a special examination given by the Ministry of Finance. Such examinations have been given on an irregular basis at intervals of several years; therefore, it cannot be predicted when the MOF will next offer this examination.

ROLES AND RESPONSIBILITIES OF STANDARD-SETTING BODIES

Professional Standards Promulgated by Each Body

5. The basic accounting principles and auditing requirements are prescribed by the Commercial Code and are supplemented by pronouncements issued by the Business Accounting Deliberation Council ("the Council"), a consultative body of the Ministry of Finance. The pronouncements include the Financial Accounting Standards for Business Enterprises (a one-package, concise, comprehensive set) and the Auditing Standards, which comprises ten standards.

6. Based on recommendations of or consultation with the Council, the Ministries of Justice and Finance have issued certain administrative ordinances and implementation orders with which a company or auditor must comply.

7. After approval was obtained from the JICPA Council, the Audit Committee of the JICPA issued a number of papers regarding auditing and accounting practices that are acceptable for independent auditors to follow when expressing their opinion on financial statements. Periodically, the JICPA has issued its own pronouncements that guide independent auditors in handling specific matters.

Ethics Requirements

8. As defined in the related implementation orders and ordinances, the Certified Public Accountants Law (the "CPA Law") and other laws prohibit a CPA from performing an independent audit when he or she has a "material relationship" with a client. Material relationship is defined in the CPA Law Implementation Order 7, which allows some financial interest in the client. Independence is not impaired if the CPA has a direct equity investment of less than yen 250,000 at face value, or has a due from or to the client less than yen 500,000. Independence is impaired if a CPA renders tax services to his or her audit client.

9. The JICPA has Disciplinary Rules that include ethics restrictions for advertising, personal relationship with client, beneficial interest in client, and competition with other CPAs based on fees. For example, there is no restriction to the proportion of total fees generated from one client. Additionally, the JICPA does not allow its members to advertise their skills, experience, or scale or results of operations of their firms.

PROFESSIONAL PUBLIC ACCOUNTING ORGANIZATIONS

Requirements for Membership

10. The JICPA was established under the CPA Law. Applicants for membership in the JICPA must have passed the third examination for CPAs, which consists of accounting practice (including income taxes), auditing practice, and financial analysis.

11. The first examination comprises mathematics, Japanese language competency and a thesis. This examination is exempted

for those who have completed the second year at a university or college. The second examination comprises accounting, cost accounting, auditing, management, economics and commercial law. Candidates successful in the second examination are entitled to register with the JICPA as a "Junior CPA" and subsequently must have at least two years' experience in the profession or in accounting-related work. Before becoming eligible to apply for the third examination, candidates must complete a one-year training course that includes all aspects of a CPA's duties while in practice.

Rights of Membership

12. The CPA Law provides that only members of the JICPA are eligible to undertake an audit of financial statements for remuneration.

Number of Members

13. The following is the number of members of the JICPA at April 30, 1987:

CPA	8,012
Foreign CPA	21
Audit corporation	89
Junior CPA	1,488
Total	9,610

CPE Requirements

14. There are no particular CPE requirements in Japan, though the JICPA periodically conducts training sessions.

2

Auditing Requirements

STATUTORY AUDITING AND REPORTING REQUIREMENTS

15. In Japan, there are two types of statutory audit requirements—(*a*) the Commercial Code and (*b*) the Securities Transactions Law. Although there are some differences in purpose and reporting requirements between the two types of audits, both are usually performed concurrently by the same auditor and comply with audit standards generally accepted in Japan.

Commercial Code Audit

16. In order to provide adequate protection to stockholders and creditors, the Commercial Code requires every *Kabushiki Kaisha* (limited liability stock corporation or "*KK*") to elect one or more statutory auditors at a general meeting of stockholders. No professional qualification is required of the statutory auditors, who can be re-elected for two-year terms.

17. Under the Commercial Code the basic responsibilities of a statutory auditor are as follows:

a. Examination of the performance of duties by the company's directors

b. Examination of the proposals and documents that directors propose to submit to the general meeting of stockholders

c. Requesting cessation of unlawful acts of directors, if applicable

d. Submission of audit report on balance sheet, profit and loss statement, business report, proposal of appropriation of profit or disposition of loss, and supporting schedules

18. The responsibility of a statutory auditor of a *KK* with a stated capital of yen 100 million or less (a "small-scale" corporation) and of a *Yugen Kaisha* (simplified form of limited liability corporation or "*YK*") is limited to items *b.* and *d.* above. A *Yugen Kaisha* is not required to appoint a statutory auditor unless such requirement is provided in the Articles of Incorporation. A *Gomei Kaisha* (unlimited liability corporation) and a *Goshi Kaisha* (corporation with general and limited liability partners) are not required to appoint a statutory auditor.

19. A *KK* with a stated capital of yen 500 million or more or total liabilities of yen 20 billion or more (a "large-scale" corporation) is required to appoint at least two statutory auditors, one of whom is employed on a full-time basis. In addition, such a *KK* is required to appoint an accounting auditor who should also be an independent CPA.

20. The statutory auditors of a large-scale corporation are not required to examine the financial statements. Instead, they are required to review the performance of the accounting auditor and express an opinion whether the accounting auditor's performance was adequate.

21. The accounting auditor is elected at a general meeting of stockholders (based on a proposal of directors after consent of a majority of the statutory auditors). The term of office of an accounting auditor ends on the day of the annual general meeting of stockholders with respect to the fiscal year for which the accounting auditor served. The term of office is automatically extended unless a contrary resolution is made by the stockholders.

22. On the other hand, the stockholders can dismiss the accounting auditor at any time by a resolution made at the general meeting of stockholders. In certain instances, such as negligence or violation of the rules of performance of professional duties, the accounting auditor may be dismissed by the common consent of the statutory auditors. In this instance, statutory auditors must report the fact of dismissal and its reason to stockholders at the first general meeting following the dismissal, during which the accounting auditor has a right to express his or her opinion regarding the dismissal.

23. Directors of a *KK* and a *YK* should prepare the balance sheet, profit and loss statement, business report, and proposal of appropriation of profit or disposition of loss (the "financial statements and business report"). Other types of corporations should submit this information to the statutory auditors seven weeks or more before the general meeting is held. Supporting schedules should be submitted to the statutory auditors within three weeks after submission of the financial statements and business report. In turn, the statutory auditors should then submit an audit report to the directors within four weeks after receipt of the financial statements and business report. The audit report should cover the following:

a. Outline of audit procedures employed
b. Whether the contents of the balance sheet and profit and loss statement agree with the related accounting records
c. If the contents of the balance sheet and profit and loss statement comply with laws, regulations and articles of incorporation, a statement to that effect
d. If the contents of the balance sheet and profit and loss statement do not comply with laws, regulations and articles of incorporation, a statement to that effect and the reason
e. Whether any change in accounting principles is reasonable
f. Whether the contents of the business report comply with laws, regulations and articles of incorporation
g. Whether the proposal of appropriation of profit or disposition of loss complies with laws, regulations and articles of incorporation
h. If the proposal of appropriation of profit or disposition of loss is remarkably improper, a statement to that effect
i. Whether the supporting schedules include all required information, and whether such information is proper
j. If any unjust acts have occurred, or if anything unlawful relative to a director's performance of duties exists, a statement to that effect
k. Disclaimers, if the examination could not be done satisfactorily

24. Directors of a small-scale corporation and, if applicable, a *YK* should submit the financial statements and business report to

statutory auditors five weeks or more before the general meeting of stockholders is held. Supporting schedules should be submitted within two weeks after the original submission of the financial statements and business report. In turn, statutory auditors should submit an audit report to the directors within four weeks after the original receipt. The scope of their audit is limited to the areas relating to accounting matters. Moreover, their audit report is not subject to the reporting requirements described in the foregoing paragraph.

25. For a large-scale corporation, statutory auditors and the accounting auditor are to receive the financial statements and business report eight weeks or more before the general meeting of stockholders and the supporting schedules within three weeks after receiving the former.

26. The accounting auditor should submit an audit report to statutory auditors and directors within four weeks after receipt of the financial statements and business report, which consists of items *a.* through *g.*, *i.* and *k.* (The accounting auditor must report on the matters concerning accounting for items *f.* and *i.*) Within one week after receiving the accounting auditor's report, the statutory auditors should then submit to the directors an audit report that covers the following:

a. If the procedures or conclusions of the accounting auditor are considered not appropriate, a statement to that effect and the reason, and a description of their procedures or conclusions

b. Items *h.*, *j.*, and *k.* and non-accounting portions of items *f.* and *i.* above

c. Outline of audit procedures employed relative to item *b.* above

27. The accounting auditor is not required to examine the conduct of the directors. However, if anything unlawful relative to a director's performance of duties is noted during his or her normal course of examination, the accounting auditor must report such fact to the statutory auditors.

Securities Transactions Law Audit

28. The purpose of the Securities Transactions Law audit is to attest to financial statements and supporting schedules included

in a registration statement, or in an annual or semiannual report filed with the Ministry of Finance, in order to protect existing and prospective investors.

29. The following corporations are required to file the statements or report, referred to in paragraph 28, with the Ministry of Finance:

a. A corporation or certain shareholders of a corporation planning to sell to the public the corporation's new or outstanding equity or debt securities aggregating yen 100 million or more

b. A corporation that has filed one or more registration statements

c. A corporation whose securities are listed or that plans to list its securities on a securities exchange

d. A corporation whose securities are traded on the over-the-counter market

30. The financial statements and supporting schedules in the registration statement (for each of the two years) or in an annual or semiannual report (current year only) should be accompanied by an audit report issued by a CPA in accordance with the Ministry of Finance Ordinance No. 12 of 1957, as amended, *Audit of Financial Statements and Related Matters.* (The limited review is not used in Japan.) Semiannual financial statements for public companies must be submitted to the Ministry of Finance. These statements require a limited audit, in which certain auditing procedures can be omitted (for example, confirmations). Japanese auditing standards provide one set of auditing standards applicable to semiannual financial statements that is composed of two parts: auditing procedures and reporting. The audit opinion should state whether the semiannual financial statements present "useful accounting information."

31. Because the scope of the audit for Commercial Code purposes as well as for Securities Transactions Law purposes substantially overlaps, a normal procedure for a corporation subject to both audit requirements is to have an accounting auditor under the Commercial Code also report on the financial statements and supporting schedules under the Securities Transactions Law.

32. Under the Securities Transactions Law, an independent auditor's report regarding the annual individual financial statements and consolidated financial statements should cover the following items:

a. Outline of the audit, which should include—
- The scope of the financial statements
- Whether the audit was performed in accordance with generally accepted auditing standards
- Whether auditing procedures normally considered necessary and those that were considered necessary under the circumstances were performed
- If another auditor's work was relied upon for an important part of the audit, a statement to that effect

b. Opinion whether the audited financial statements and supporting schedules fairly state financial position and results of operations, which should include—
- Whether the accounting principles and procedures employed by the corporation are in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year
- Whether the presentation of the financial statements is in conformity with the provisions of the related Ministry of Finance Ordinance(s)

c. Supplementary information, including subsequent events not included in the financial statements.

33. For a semiannual audit report on semiannual financial statements, the requirements that are listed in paragraph 32 must be changed as follows:

a. The terms "financial statements" and "audit" are to be replaced by "semiannual financial statements" and "semiannual audit"

b. Item *b.* is replaced by a query whether the interim financial statements present "useful accounting information" relative to the semiannual period which constitutes a portion of the fiscal year

34. The Securities Transactions Law audit report is addressed to the representative director of a corporation.

SUMMARY OF SIGNIFICANT AUDITING STANDARDS AND COMPARISON WITH U.S. GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

Standards Issued

35. Japanese auditing standards were issued and have been modified by the Business Accounting Deliberation Council, the preface of which states, in part, that "professional auditors shall follow [the standards] even if they are not specifically required by laws or regulations." Accordingly, it is understood that the auditing standards should apply to a Commercial Code, Securities Transactions Law or voluntary audit. The Japanese auditing standards consist of four general standards, three fieldwork standards and three reporting standards, and correspond respectively to the three general standards, three fieldwork standards and four reporting standards used in the United States. The standards are supplemented by separate sets of working rules of fieldwork and reporting, both issued by the Council.

36. The Council also issued *Auditing Standards for Interim Financial Statements* as a part of *Opinion on Financial Statements to be Presented in an Interim Report.*

37. In order to supplement the foregoing standards, the Audit Committee of the JICPA has issued a number of papers concerning auditing matters such as confirmations, observation of inventories, part of an examination made by other independent auditors, and draft format of various audit reports, among others. (See appendix D for a summary comparison of U.S. and Japanese auditing standards.)

General Standards

38. Matters similar to those discussed in the U.S. general standards are covered by the corresponding general standards in Japan. In addition, the Japanese general standards require that an auditor should have no material conflict-of-interest relationship with the clients, and that an auditor should not, without justifi-

cation, divulge or covertly use information obtained in the course of his or her professional work.

39. Under the CPA Law Implementation Order, CPAs are prohibited to render tax advisory services to their audit clients, but are allowed to make a limited amount of investments in their audit clients.

Standards of Fieldwork

40. Matters similar to those discussed in the standards of fieldwork in the U.S. are covered by the corresponding standards of fieldwork in Japan. The phrase, "inspection, observation, inquiries, and confirmations to afford a reasonable basis," is not covered by auditing standards in Japan. Rather, it is covered by individual procedures under the *Working Rules of Field Work.*

41. The *Working Rules of Field Work* are composed of *(1)* general and *(2)* customary auditing procedures, and the latter are divided into those related to *(a)* unconsolidated financial statements and *(b)* consolidated financial statements. The working rule *(2a)* covers auditing procedures for preliminary review, records of transactions and financial statement items, and *(2b)* covers auditing procedures for preliminary review, basic items, consolidation, and presentation of consolidated financial statements.

42. In the area of fieldwork, Japanese auditing standards differ from those employed in the United States in the following ways:

- Written representation from management is not specifically required.
- Direct communication with legal counsel is not required unless there are matters associated with subsequent events.
- Currently, there are no working rules or guidelines requiring the auditor to—
  - *a.* Test shipping and receiving cutoff procedures relative to inventories.
  - *b.* Consider the effect of an internal audit function on the scope of the examination.

c. Communicate material weaknesses in internal accounting control to senior management or the board of directors.

d. Prepare written audit programs.

e. Give consideration to a question concerning an entity's continued existence.

f. Differentiate between substantive tests and compliance tests.

Standards of Reporting

43. The standards of reporting set forth the following:

a. The auditor should state clearly in his or her report the scope of the work performed and his or her opinion on the financial statements.

b. In expressing an opinion on the financial statements, the auditor should state whether the financial statements examined present fairly the financial position and results of operation of the enterprise.

c. In his or her report, the auditor should disclose items that may not affect the financial statements under examination but may have a material effect on future financial statements.

44. The *Working Rules of Reporting* consist of (*a*) preparation of audit reports, (*b*) scope of audit, (*c*) opinion on financial statements, (*d*) disclaimer of opinion on financial statements, and (*e*) subsequent events.

45. Reporting requirements under the Commercial Code and the Securities Transactions Law are described in paragraphs 15 through 34.

46. Significant differences in the reporting area between Japanese and U.S. auditing standards, include the following. In Japan—

- Although reference is made to other auditors who have been relied upon, no division of responsibility is permitted with reference to other auditors in the opinion paragraph.
- There is no requirement that an auditor's report should cover not only the financial statements of the current period, but also those of one or more prior periods presented on a comparative

basis. If a report is required for more than one year, a separate report must be issued for each year.

- Auditing standards require an opinion regarding whether the form and content of the financial statements comply with either generally accepted standards or with the related regulations concerning form and content of financial statements.
- Auditing standards require that an auditor disclose important exceptions and their effect on the financial statements. In practice, it is understood that a qualified opinion, except for qualifications as to consistency, should not be issued either for Securities Transactions Law audit purposes or for Commercial Code audit purposes.
- The CPA Law requires a statement made in an audit report as to whether the reporting auditor has any relationship as specified with the client.

Standard Form of Report

47. The following report forms are suggested by the Audit Committee of the JICPA:

a. Accounting auditor's report for Commercial Code audit purposes

b. Auditor's reports on unconsolidated and consolidated financial statements under the Securities Transactions Law

c. Auditor's report on interim (semiannual) financial statements

The standard forms are modified when an exception is noted, or a disclaimer or adverse opinion is to be issued.

Qualifications in Audit Report

48. Based on the *Working Rules of Reporting* and various regulations, guidelines, and the Audit Committee papers, qualifications are summarized as follows:

a. *Scope limitation.* Reference is made in the scope paragraph with reasons.

b. *Important exceptions.* Disclosed in the opinion paragraph. In such case, no overall opinion should be expressed in a Commercial Code audit. For Securities Transactions Law purposes, if the exception is not so serious that it is considered that the financial statements do not present fairly as a whole, a "fair" opinion is to be given, and if otherwise, an adverse opinion.

c. *Inconsistency (concurred in).* Reference is made in the opinion paragraph. Under the Commercial Code, the reason for concurrence also should be given in the opinion paragraph.
d. *Inconsistency (not concurred in).* The same treatment as "important exception."
e. *Uncertainty.* Reference is made as supplementary information with unqualified opinion; if otherwise, a disclaimer of opinion should be given.

Dating of Audit Reports

49. The *Working Rules of Reporting* state that an auditor's report should be dated as of the date of preparation. The practice of dual dating for subsequent events, accordingly, does not exist in Japan.

Other Auditors

50. If the principal auditor relies on the work of other auditors related to a significant part of the financial statements, he or she should so indicate in the scope paragraph of the report. Although it is commonly understood that the principal auditor must assume responsibility for the work of the other auditors, the Ministry of Finance will not blame the principal auditor if the other auditors' work is later proven to be insufficient.

51. The concept of a *joint audit* exists in Japan whereby two or more auditors jointly audit a corporation's financial statements and jointly sign an audit report thereon.

3

Accounting Principles and Practices

SOURCES OF ACCOUNTING PRINCIPLES

52. The basic accounting principles that must be followed by commercial enterprises in Japan are prescribed by the Commercial Code of Japan. The Code stipulates the financial reports that are to be prepared and lays down the general rule that sound accounting practices shall be adhered to when maintaining the books of account.

53. The accounting principles prescribed by the Commercial Code are supplemented by the *Financial Accounting Standards for Business Enterprises* formulated by the Business Accounting Deliberation Council. The standards, presented as a one-package, concise, comprehensive set, comprise (*a*) general standards, (*b*) profit and loss statement standards, and (*c*) balance sheet standards, and are supplemented by twenty-five notes to the standards. In addition, the Council has issued separately standards or opinions relative to consolidated financial statements, interim financial statements, cost accounting, foreign currency translation and liability for retirement allowances.

54. In order to supplement accounting principles stipulated by the Business Accounting Deliberation Council, the Audit Committee of the JICPA (the "Audit Committee") has issued a number of papers relative to accounting practices acceptable for independent auditors to follow in expressing their opinion on financial statements. From time to time, the Institute itself has issued several pronouncements that guide independent auditors in handling specific matters.

55. Since an income tax return should be prepared based on the financial statements approved by the shareholders at a general shareholders' meeting, certain provisions for expenses and write-downs of assets are acceptable for tax purposes, if recorded on the books of account, and Japanese tax authorities have issued comprehensive regulations relative to accounting practices acceptable for tax purposes. These tax regulations have significantly influenced the selection of accounting practices by Japanese companies. Because the tax laws and regulations over allowances and disallowances for tax purposes are the most comprehensive when compared with the aforementioned sources, many companies tend to follow those laws and regulations, unless they clearly contradict generally accepted accounting principles.

FORM AND CONTENT OF FINANCIAL STATEMENTS

Presentation of Statements

56. Under the Commercial Code, directors of a company are required to prepare for each accounting period a balance sheet, a profit and loss statement, a business report, and a proposal of appropriation of profit or disposition of loss, together with supporting schedules. There is no requirement that such financial statements be prepared on a comparative basis. Copies of such documents, except for the supporting schedules, together with a statutory auditors' opinion thereon, are to accompany any notice to stockholders of a stockholders' general meeting. The original documents, or conformed copies, are retained at the head office and branch offices of the company for a certain period of time for inspection by stockholders and creditors. The balance sheet, profit and loss statement and proposal of appropriation of profit or disposition of loss are to be approved by the stockholders at a general meeting. If independent auditors examine the financial statements under the Commercial Code requirements, the financial statements, except for the proposal of appropriation of profit or disposition of loss, are finalized upon issuance of an unqualified opinion by the independent auditors and the agreement of the statutory auditors with the independent auditors' opinion. After obtaining the approval of financial statements by the stockholders

at a stockholders' general meeting, the directors shall give public notice of the balance sheet (and profit and loss statement for a large-scale corporation).

57. Under the Securities Transactions Law of Japan, Japanese companies that are listed on securities exchanges or have sold securities to the public in the amount of yen 100 million or more are required to file an annual report within three months subsequent to the end of a fiscal year with the Ministry of Finance after the stockholders' general meeting is held and the financial statements are approved. This annual report should include, among other data, balance sheets, profit and loss statements and statements of appropriation of profit or disposition of loss for the current and previous fiscal years and schedules of certain accounts and transactions for the current year. For companies whose fiscal year comprises a twelve-month period, a semiannual report shall also be filed within three months subsequent to the end of the semiannual period.

58. The formats of the balance sheet and profit and loss statement under the Commercial Code are prescribed by the Ministry of Justice Ordinance No. 31 of 1963, as amended, *Regulation Concerning the Balance Sheet, Profit and Loss Statement, Business Report and Supporting Schedules of Kabushiki Kaisha.* The terminology, forms, and method of preparation of the financial statements under the Securities Transactions Law are prescribed by the Ministry of Finance Ordinance No. 59 of 1963, as amended, *Regulations Concerning Financial Statements, and Related Matters.*

59. Although a more detailed presentation of assets, liabilities, income and expenses and full financial statement disclosure is required under the Securities Transactions Law, the structure of the parent-only financial statements required under the Securities Transactions Law is essentially the same as that under the Commercial Code.

60. The balance sheet should be divided into sections for assets and for liabilities and stockholders' equity, and the asset section should be divided into current assets, noncurrent assets and deferred charges. Noncurrent assets should further be divided into subsections for tangible fixed assets, intangible fixed assets and investments. Liabilities should be divided into current and noncurrent classifications. Stockholders' equity should be

divided into capital stock, legal reserves and retained earnings (Commercial Code) or capital stock, capital surplus, legal reserve retained from earnings, and retained earnings (Securities Transactions Law).

61. The profit and loss statement should be divided into ordinary profit and loss and extraordinary profit and loss. Ordinary profit and loss should be subdivided into operating profit and loss and nonoperating profit and loss, and operating profit (or loss) and ordinary profit (or loss) figures should be presented. Extraordinary profit and loss include—

a. prior period adjustments
b. profit (or loss) on sale of fixed assets, including intangible assets and investments
c. other extraordinary profit and loss

After extraordinary profit and loss have been added to ordinary profit and loss, profit (or loss) before income taxes should be shown, and net profit (or loss) should be presented after deduction of income taxes. To net profit (or loss), profit (or loss) brought forward (after appropriation of profit or disposition of loss), interim dividend and related transfer to legal reserve retained from earnings, and reversal of certain reserves, if any, are added or deducted, and the statement ends with unappropriated retained earnings or undisposed deficit at the end of the year.

62. Preparation of business reports and certain supporting schedules, as well as certain disclosures, are exempted for small-scale corporations.

63. Neither the Commercial Code nor the Securities Transactions Law requires a statement of changes in financial position.

Types of Statements Prepared

64. Under the Commercial Code, the statements and supporting schedules should be prepared on a parent-company-only basis. There is no requirement that they should be presented on a comparative basis.

65. The Securities Transactions Law prescribes that annual individual (parent company only) financial statements and con-

solidated financial statements, if applicable, as well as semiannual financial statements (parent only) be filed with the Ministry of Finance together with other data. The terminology, forms and methods of preparation of consolidated and interim financial statements are prescribed by Ministry of Finance Ordinances, No. 38 of 1977, *Consolidated Financial Statements and the Related Guidelines* and No. 28 of 1976, *Interim Financial Statements and the Related Guidelines* (parent only), both as amended. The related Ordinances require that the annual parent-only and consolidated financial statements be presented on a comparative basis with those of the preceding year.

66. The consolidated financial statements are required to be prepared on an annual basis only and comprise (*a*) balance sheets, (*b*) profit and loss statements, and (*c*) statements of profit appropriation or loss disposition. The consolidated profit and loss statements end with net profit (or loss).

67. The semiannual statements consist of only balance sheets, and profit and loss statements. The balance sheets as of the corresponding date of the prior year and the latest year-end, and the profit and loss statement for the corresponding period of the prior year should also be presented for comparative purposes.

SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES AND COMPARISON WITH U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Historical Cost Basis

68. The Commercial Code requires that current assets be stated at cost (or market for a *Gomei Kaisha* and a *Goshi Kaisha*), except when market is significantly less than cost and not expected to recover, in which case they must be valued at market. Fixed assets should be stated at cost less accumulated depreciation. When unexpected impairment of their value occurs, they should be appropriately written down. Receivables should be stated net of allowance for doubtful receivables. (There are no other requirements for a *Gomei Kaisha* and a *Goshi Kaisha*.)

69. Current cost accounting has not been adopted, even for supplementary purposes.

Marketable Securities

70. Temporarily owned marketable debt and equity securities should be carried at cost or the lower of cost or market on an individual basis, rather than on a portfolio basis. Investment securities should be carried at cost, except that they should be written down to reflect any permanent decline in value by a corresponding charge against income.

Notes Discounted and Endorsed

71. Notes discounted and endorsed are treated as contingent liabilities, and the balances as of the balance sheet date are required to be disclosed.

Inventories

72. Japanese companies may value inventories at either cost (except when market is significantly less than cost and not expected to recover, in which case they must value such inventories at market) or the lower of cost or market. The last purchase cost method is also used as permitted under the tax laws.

Prepaid Expenses

73. Under income tax regulations, companies other than banks and other finance companies are permitted to write off recurring prepaid expenses that would otherwise be charged to expense within one year. The Audit Committee agrees with such practice if it does not distort periodic income.

Allowance for Doubtful Receivables

74. Under tax laws, a general bad debt provision calculated, based on predetermined percentages against receivables, which are regulated by the tax law, is allowable for tax purposes. Audit Committee paper no. 5, *Accounting for and Financial Statement Presentation of Reserve for Doubtful Receivables and Auditor's Opinion,* as amended, prescribes that it is acceptable for a company to provide an allowance for doubtful receivables up to the limit allowable for tax purposes, provided that such amount is not less than the amount required under generally accepted accounting principles.

Investments in Subsidiaries and Affiliates

75. Investments in subsidiaries and affiliated companies should be stated at cost on the parent-only financial statements. If the equity in an investee declines significantly below cost and is not expected to recover, the investment should be written down to reflect this decline. The equity method is adopted only for consolidation purposes.

Deferred Charges

76. Deferred charges permitted to be capitalized under the Commercial Code and their amortization periods are as follows: goodwill, organization expenses, preoperation expenses, research and development expenses (within five years), stock and bond issue expenses (within three years) and bond discount (over the period to maturity of bonds). Stock issue expenses may not be charged to additional paid-in capital.

77. Goodwill may be recorded as a deferred charge only when it is acquired for a consideration or through merger and consolidation. Research and development expenses permitted to be capitalized are limited to those expenditures with respect to (*a*) research for new products and new techniques, (*b*) adoption of new techniques and new management structure, (*c*) development of resources, and (*d*) development of markets.

Retirement Allowances

78. Historically, Japanese companies have adopted employee retirement and severance benefit plans, under which the employees are entitled to lump-sum payments based on, in general, current rate of pay and length of service at their termination. In the past, the plans were generally not funded, but there is now a tendency to fund them partially.

79. The tax regulations limit the extent of deductibility of the liability for employee retirement and severance benefits for tax purposes to a maximum of 40 percent of the voluntary severance liability computed as of the balance sheet date. Opinion 2 of the Business Deliberation Council, *Establishment of Liability for Retirement Allowance,* supplemented by JICPA pronouncements and

Audit Committee papers, prescribes that it is acceptable for a company to provide for financial statement purposes the tax allowable limit, 50 percent of the voluntary severance liability (the tax allowable limit before revision of the tax law), 100 percent of the voluntary or involuntary severance liability, the estimated liability computed under an acceptable actuarial cost, or another method. Accordingly, a company chooses one of the above methods after taking various factors into consideration.

Installment Sales

80. Revenue from installment sales should be recognized when the goods are delivered. However, acknowledging that uncertainties exist relative to bad debts, collection expenses and after-service costs, revenue is allowed to be recognized when the installment payment becomes due or when payment is received. The installment basis is allowed for tax purposes if a company records sales on that basis on the books of account; therefore, many companies record sales on the installment basis.

Leases

81. No authoritative literature has been issued with respect to leases to date, and most leases are accounted for by both lessors and lessees as operating leases. Due to an increase in the financial lease business, the tax authorities issued a regulation in 1978. (See paragraph 56 relative to the influence of tax regulations on accounting practices.) This regulation requires that the following leases be accounted for as sales and purchase type leases:

a. The lessee has a bargain purchase or renewal clause after the expiration of the lease term.

b. Leased property is land, buildings, building auxiliary facilities or structures or both.

c. Leased property is machinery and equipment made specifically for the lessee and cannot be leased to others.

d. The leased property is scaffolding, which is difficult to identify due to the conditions of use.

e. The lease term is less than 60 percent (70 percent if useful life is less than ten years) of the useful life stipulated by the tax regulations, and the lessee has a bargain purchase option.

Interest Cost

82. Except for real estate development companies, capitalization of interest cost is not generally accepted.

Income Taxes

83. Income tax expense shown in nonconsolidated financial statements represents the taxes that are levied on taxable income for the reporting period. Income taxes constitute the corporation tax levied by the national government, the prefectural and municipal inhabitants taxes levied by local governments, and income tax on interest and dividend income withheld at source. Business tax is also levied based on income, except for electric power companies, gas companies, and life and casualty insurance companies. The Ministry of Finance requires that this tax be included in selling, general and administrative expenses. Audit Committee paper no. 45 agrees with the classification "in principle."

84. Income taxes should consist of the amounts currently payable that are net of the tax effect of a loss brought forward. If a refund is reasonably certain, a loss carryback may be applied in the determination of net income or loss of the loss period.

85. The concept of interperiod income tax allocation, for example, the recognition of the future tax effects of timing differences in reporting income and expense for tax and financial statement purposes, is considered not acceptable in Japan in the preparation of unconsolidated financial statements. However, this concept may be followed in the preparation of consolidated financial statements, either on a comprehensive or partial allocation basis.

Bonuses to Directors and Statutory Auditors

86. Bonuses to directors and statutory auditors are approved by the shareholders and are regarded as a distribution of profits rather than as an expense of operations. Accordingly, the bonuses are charged against retained earnings.

Dividend and Free Distribution of Shares

87. A dividend is payable based on approval by the stockholders of the proposal of appropriation of profit, and accord-

ingly, the amount of a proposed dividend is included in unappropriated retained earnings in the balance sheet. The Board of Directors may resolve the payment once a year of an interim dividend from profit brought forward (payment not permissible from current earnings). Such interim dividend also is not reflected on the interim balance sheet until the resolution is made.

88. The Commercial Code provides that a company may transfer legal reserve to capital stock and that it may distribute profit in the form of stock dividends. In connection with share offerings, the practice has been followed of granting free distributions of shares out of additional paid-in capital, which range from 5 percent to 25 percent of outstanding shares. The Code requires that stock dividends or free distributions be accounted for by transfer of an amount equivalent to the par value (not fair value) of the shares issued from additional paid-in capital (if applicable), legal reserve or retained earnings to the capital stock account.

89. Effective October 1, 1982, the gross proceeds from sale of new shares or the aggregate conversion price of conversions into common stock of convertible debt should be credited to the capital stock account, although one-half or less of the amount may be credited to the additional paid-in capital account. As a result, if the balance of the capital stock account in excess of the aggregate face value of the outstanding shares exceeds the aggregate face value of the shares issued free, there is no requirement to transfer the amount equivalent to the par value from additional paid-in capital, and there is no change in the structure of the stockholders' equity account.

Foreign Currency Translation

90. Under Japanese accounting principles, current receivables and payables that are denominated in foreign currencies, except for convertible debt due within one year, should be translated at current rates. Investments, long-term receivables and payables, and convertible debt due within one year should be translated at historical rates of exchange, except that if there has been a significant change in exchange rates, the receivables and payables may be translated at the current rate in the year of the change in exchange rate. This current rate then becomes the historical

rate for the purpose of translations in subsequent financial statements. If there is a forward exchange contract for hedging relative to a current asset or liability item, such asset or liability item should be translated at the related forward rates. If there are noncurrent receivables and payables, the difference between the amounts translated at historical rates and at forward contract rates should be deferred and amortized on a reasonable basis.

91. Resulting gains or losses on translation of foreign currency transactions are included in determining net income. The financial statements of foreign branches are translated into Japanese yen as follows:

a. Monetary items and securities are translated by the same method as that used by the head office.
b. Nonmonetary assets, and advance receipts and deferred credits, as well as the associated charges and credits to operations, are translated at historical rates.
c. Revenue and expenses other than described in *b.* above are translated at historical rates or average rates.
d. Resulting translation difference is charged or credited to operations.

92. The financial statements of foreign subsidiaries and affiliated companies are translated into Japanese yen as follows:

a. Current monetary items are translated at the rate at the balance sheet date. Noncurrent monetary items, securities and nonmonetary items are translated at historical rates. The associated charges and credits to operations arising from nonmonetary items are also translated at historical rates.
b. Revenue and expenses other than described in *a.* above are translated at average rates.
c. Net income or loss for the period and retained earnings or deficit at the end of the period are translated at the rate at the balance sheet date.
d. Resulting translation difference is to be presented as an asset or liability item on the balance sheet as "translation difference."

Accounting Changes

93. The accounting principles adopted by a company should not be changed except for good reason. If a change in accounting

principles is made, disclosures are required as to the fact of and the effect of such a change. Cumulative effect of the accounting change is not explicitly required to be presented on the profit and loss statement, and no disclosure is required to be made as to pro forma effects of the change. A retroactive restatement of financial statements is not made except in extraordinary cases, which are extremely rare, because, in such a case, an approval of profit appropriation based on the restated financial statements or the restated financial statements themselves is required to be obtained at a stockholders' meeting.

Business Combinations

94. Acquisitions and mergers do not often take place in Japan, and accordingly, no authoritative literature in this area has been provided. In practice, acquisition of an entity is regarded as an investment in the entity. This transaction does not affect the financial statements of the acquired entity, and no push down basis of accounting takes place. In the investor's books of account, the investment is recorded at cost, and no cost-over-equity problem arises, other than for consolidation purposes. Mergers are performed usually by an exchange of the shares of the acquired enterprise with those of the acquiring enterprise (possibly with a certain amount of money involved). Mergers are accounted for by the pooling-of-interest method.

Futures Contracts

95. A debt securities futures exchange was established in 1985, and the JICPA issued a pronouncement, as an interim measure, that profit and loss on a futures transaction on debt securities be recognized when the transaction is settled, and that any material unrealized loss on futures transactions other than for hedging purposes as of a balance sheet date should be disclosed.

Real Estate Transactions

96. Real estate transactions have not been given much attention by accountants, and no particular pronouncements have been issued to date regarding them.

Other Matters

97. Neither the Commercial Code nor the Financial Accounting Standards of Japan deal with a number of matters covered by U.S. generally accepted accounting principles due in part to the difference in business environments. (See appendix E for a summary comparison of U.S. and Japanese accounting principles.) The more significant areas not addressed in Japan include the following:

- Commitments: long-term obligations
- Compensation to employees: paid absences
- Convertible debt, conversion of convertible debt, and debt with stock purchase warrants
- Debt: extinguishments, product financing arrangements and restructuring
- Interest: imputation of interest cost
- Nonmonetary transactions
- Segment of business reporting

4 Business Environment

FORMS OF BUSINESS ORGANIZATION

98. The forms of business organization that exist in Japan are the individual proprietorship and the company. A partnership is not a recognized legal entity in Japan, though there are forms of companies called a *Gomei Kaisha* and a *Goshi Kaisha* under the Japanese Commercial Code, which are in substance similar to the partnership in the United States. Regardless of the form of business organization, the Commercial Code requires that it maintains books of account and prepare a balance sheet at least once a year.

Entities With Corporate Attributes

99. The Japanese Commercial Code provides that a company may be registered in one of the following forms:

a. *Kabushiki Kaisha* (*KK*)—A company in which the liability of a shareholder is limited to the amount of his shareholding. The great majority of businesses are formed as a *KK*.

b. *Gomei Kaisha*—A company composed of members with unlimited liability.

c. *Goshi Kaisha*—A company composed of certain members with unlimited liability and others with limited liability.

100. An additional form of business organization is a limited company called a *Yugen Kaisha* (*YK*), which is incorporated under

a special statute. A *Yugen Kaisha* is normally formed by small or closely held businesses.

101. A *KK* and a *YK* must hold an ordinary general meeting at least once a year. When deemed necessary an extraordinary general meeting may be convened not only by the board of directors but also by the liquidators and shareholders of a *KK* who hold shares representing 3 percent or more of the total shares issued during the last six months. The resolution by a general meeting shall be sought only with respect to the matters provided for in the Commercial Code or the articles of incorporation.

102. If there are shares not paid for after the company comes into existence, the promoters who initially formed the company are jointly liable for that payment. The liability of a shareholder is limited to the amount of shares held. Directors are fiduciaries and must act in good faith in the shareholders' interest. If there are new shares for which payment has not been made after registration of such capital increase, directors are jointly liable to subscribe to those shares.

103. Directors are jointly and severally liable for causing damage to the company, such as illegally distributing dividends, illegally offering an interest in property, illegally lending money to other directors, and any other illegal transactions that violate any laws, ordinances or the articles of incorporation.

104. Directors' duties include the following:

- Preparation of financial statements, business report and supporting schedules and submission thereof to the statutory auditors (and the independent auditors, if applicable)
- Maintenance at the head office and the branch offices of the financial statements, business report and supporting schedules, and the audit report thereon for inspection by shareholders and creditors
- Reporting to the ordinary general meeting on financial statements
- Public disclosure of the balance sheet

105. The Commercial Code also provides that a *KK* must elect one or more statutory auditors who will examine the performance of duties by the Company's directors. If the auditors

neglect any of their duties, they are jointly and severally liable for damages to the company.

106. The Commercial Code provides that the amounts of additional paid-in capital, and surplus on capital reduction and amalgamation, be set aside as capital surplus reserves. The Code also provides that an amount equivalent to at least ten percent of a cash dividend be set aside as a legal reserve retained from earnings until such reserve equals 25 percent of stated capital. Both reserves may be used to reduce a deficit or may be transferred to stated capital.

Branch of a Foreign Company

107. The Commercial Code provides that if a foreign company intends to engage in commercial transactions as a continuing business in Japan, the company shall appoint a representative in Japan and establish an office, effect its registration, and give public notice relative to the office, the law based on which the company was organized and the name and address of the representative of the company in Japan.

108. A foreign company that has established a branch in Japan is deemed as a company formed in Japan either of the same nature or type it most closely resembles. Accordingly, the responsibility and liability of the branch of a foreign entity are the same as those of Japanese companies and are deemed as those of the head office in a foreign country.

109. In other words, the head office in the foreign country that has established a branch in Japan should take full responsibility for the commercial activities of the branch and the representative of the branch.

Partnership Entities

110. There is no recognized form of business organization in Japan comparable with the partnership in the United States. However, the concept of organizations such as an undisclosed association (*Tokumei Kumiai*), a *Gomei Kaisha* and a *Goshi Kaisha* is somewhat similar to that of a U.S. partnership.

111. A contract of undisclosed association is formed when the parties agree that an undisclosed party shall make a contribution toward the business of the others, and all shall divide any profit that arises from such business. The contribution belongs to the proprietor of the business, and the undisclosed party does not acquire rights or assume obligations with regard to third parties. The *Tokumei Kumiai* is not a legal entity.

112. Under the Commercial Code, a *Gomei Kaisha* forms corporations with only unlimited liability members while a *Goshi Kaisha* does so with both unlimited and limited liability members.

113. A member of a *Gomei Kaisha* and an unlimited liability member of a *Goshi Kaisha* are respectively allowed to make their contribution in the form of personal services or credits other than property. However, limited liability members of a *Goshi Kaisha* and members of undisclosed associations are allowed to contribute their investments only in the form of cash or other property.

114. The liability of each member of a *Gomei Kaisha* (and each unlimited liability member of a *Goshi Kaisha*) is unlimited. In general, a limited liability member of a *Goshi Kaisha* has a right of inspection of the balance sheet and review of the business and the state of assets and liabilities at the end of the year. There are no specific accounting, auditing, and disclosure requirements regarding a *Gomei Kaisha* and a *Goshi Kaisha,* other than those relating to accounting matters applicable to a sole proprietor. A limited liability member of a *Goshi Kaisha* is not allowed to administer the affairs of or represent the company.

Other Forms of Business Organization—Sole Proprietor

115. A sole proprietor (referred to in Japan as a *sole trader*) is an individual engaged in a business or profession on his or her personal account. A sole trader should maintain books of account and prepare a balance sheet at least once a year. There are also certain requirements under the Commercial Code regarding valuation of assets. It is not necessary to audit or publicly disclose the accounts of a sole trader.

REQUIREMENTS FOR PUBLIC SALES OF SECURITIES AND REQUIREMENTS FOR LISTING SECURITIES ON STOCK EXCHANGES

Registration Requirements for Public Sale

116. In compliance with the requirements under the Securities Transactions Law, an offer to sell new securities must be accompanied by the registration statement (a two-part document) that, together, are filed with the Securities Companies Association. Upon approval of the registration statement by the Securities Companies Association, a prospectus is filed with the Ministry of Finance. There is no requirement to have a public offer of sale underwritten. A prospectus must include the financial statements with auditors' reports thereon for the last two years. The consolidated financial statements with the accompanying auditors' reports for the last two years are also included in the prospectus.

Requirements for Listing Securities on Major Stock Exchanges

117. The Securities Transactions Law and its related regulations set forth all the requirements for the data to be included in a registration statement filed for listing. The registration statement (a two-part document) is filed with the stock exchange on which the company plans to list. The auditors are required to submit a report to the stock exchange with respect to the system of internal accounting control that outlines the scope and results of audit.

118. Upon approval of the registration statement by the stock exchange, a prospectus is filed with the Ministry of Finance. Both the registration statement and the prospectus must include the financial statements with auditors' reports thereon for the last two years. The consolidated financial statements with the accompanying auditors' reports for the last two years are also included in the prospectus.

119. Once listed, a company must file with the Ministry of Finance its annual and semiannual reports with independent auditors' report thereon within three months after the end of the annual and semiannual periods. In accordance with the Commercial Code, circularization to stockholders of a business report, including financial statements with outside auditors' report thereon

and statutory auditors' report to stockholders, is made together with a notice of convocation of the annual stockholders' meeting.

Impact on Accounting Requirements

120. In most cases, if the financial statements included in the registration statement and the prospectus referred to in paragraphs 116 through 119 above are adjusted before their submission to the regulatory bodies to conform with the financial accounting standards of Japan, then an unqualified opinion on those financial statements may be expressed by the independent auditors. Without the unqualified opinion, the application for public trading securities on the stock exchange or the unlisted securities market may be rejected.

TAXES

Principal Types

121. The principal taxes in Japan are corporation income taxes, business occupancy tax and individual income taxes. Other taxes include payroll taxes, registration and real property acquisition tax, fixed asset tax, and a surtax on capital gains on land.

Corporation Income Taxes

122. Japanese corporation income taxes consist of the national corporation tax at 43.3 percent of taxable income, local business tax at a basic rate of 12 percent and not to exceed 13.2 percent of taxable income, and prefectural and municipal inhabitants taxes at a basic rate of 17.3 percent and not to exceed 20.7 percent of the corporation tax amount. As business tax is deductible for tax purposes for the period in which it becomes due, the effective corporate tax rate is 56.1 percent to 57.8 percent. Income tax of 20 percent is withheld at source from interest and dividend income, and such tax is deductible from the national corporation tax liability.

123. Domestic corporations are liable for corporate income taxes on income for each accounting period. Taxable income represents the net of gross revenue less costs, expenses and losses, no matter where they accrue, calculated in accordance with

Japanese accounting standards and adjusted in accordance with the requirements of the tax laws.

124. Foreign corporations are liable for taxes on income derived from sources within Japan. The scope of taxable income and the manner in which income taxes are payable differ depending on how the corporations stand for Japanese tax purposes.

125. Under the Japanese tax law, foreign corporations are classified as those operating in Japan through a permanent establishment, those not having a permanent establishment in Japan but having income that is subject to corporation tax only, and other foreign corporations whose income from Japanese sources, if any, is subject only to withholding tax.

126. A "blue form" return system was implemented to encourage taxpayers to maintain proper accounting records and to make an honest self-assessment. Taxpayers who maintain such proper accounting records are given certain privileges, such as the carryforward of losses for five succeeding years, carryback of losses for one preceding year (this has been suspended through the year 1990), special depreciation where applicable, and the establishment of reserves, among others. Tax amendments effective April 1986, have further suspended the deduction of tax losses. As a result, for accounting periods ending between April 1, 1986, and March 31, 1988, a tax loss declared for the preceding one year cannot be deducted for tax purposes for these two years.

127. A domestic family corporation, one in which 50 percent or more of the total outstanding shares are held by not more than three shareholders, is liable for a special tax on earnings retained for each accounting period. Inhabitant taxes are also payable on the special tax at the rate of 17.3 percent to 20.7 percent.

Business Occupancy Tax

128. The business occupancy tax is assessable by "designated cities" (determined from among those having a population of 300,000 or more) on corporations or individuals operating a place of business, or corporate or individual owners of a building newly built or expanded for business use in a designated city. The taxable basis is determined by the space of premises for business use and the gross payroll.

Individual Income Taxes

129. Individual income taxes comprise a national income tax, and prefectural and municipal inhabitant taxes. The inhabitant taxes are assessed based on income for the preceding year.

130. Income tax rates range from a low of 10.5 percent on annual taxable income up to yen 500,000 to a maximum of 70 percent on annual taxable income over yen 80 million. The standard inhabitant tax rates range from 4.5 percent on annual taxable income up to yen 200,000, up to a maximum of 18 percent on annual taxable income over yen 49 million.

131. In determining the tax liabilities of foreign nationals and the method of payment of their taxes, it is of primary importance to determine the categories into which they should be classified. Depending on the categories, the scope of their taxable income, the tax rates applicable thereto and the method of payment are different.

132. A *permanent resident* is an individual who intends to reside in Japan permanently, or has been domiciled or resident in Japan for a period of more than five years. He is taxable on his worldwide income.

133. A *non-permanent resident* is an individual who has been resident or domiciled in Japan for a continuous period of five years or less without intention to reside or have domicile in Japan permanently. He is taxable on income earned or derived in Japan, and any amounts earned or derived outside of Japan that are remitted into Japan.

134. A *non-resident* is an individual who has no domicile or has not been a resident for a continuous period of one year or more in Japan. He is taxed at the flat rate of 20 percent on gross remuneration, including salaries, wages, pensions and other allowances of a similar nature, but is not liable for inhabitant taxes.

135. If a non-resident, a non-permanent resident or a permanent resident departs from Japan, a quasi-final return is required to be filed by the day of his or her departure covering the period January 1 to the date of the departure. Instead of facing a quasi-final return before his or her departure, a departing resident may appoint a tax agent to administer his or her tax affairs.

Other Taxes

136. Payroll taxes—social and labor insurance laws are applicable to all employees in Japan, and premiums are borne by employers and employees.

137. When real property is acquired, a registration tax at five percent of the appraised value and a real property acquisition tax of four percent are assessed and payable to the tax office.

138. The fixed assets tax is assessable on both real property and depreciable assets for business use at 1.4 percent of the appraised value of such real property and depreciated value of the depreciable assets, and an additional 0.3 percent city planning tax is assessable on real property.

139. A surtax of 20 percent on capital gains from the sale of land held for ten years or less is payable over and above the corporation tax on taxable income, which includes the capital gains on which the surtax is payable. Taxable transactions also include the sale of shares of a corporation of which 70 percent or more of the value of the assets of such corporation is represented by short-term possession land.

Tax Returns

140. Unless extended, corporate income tax returns must be filed within two months after the end of each accounting period. Automatic extensions are granted for one month upon submission of the required application. Further extensions are difficult to obtain by domestic corporations except in cases of calamity or similar situations.

141. A final return must be accompanied by financial statements and supporting schedules. Moreover, a foreign corporation is required to submit overall financial statements. A corporation with an accounting period exceeding six months is required to file returns covering the first six months of the accounting period and pay taxes thereon if the tax is yen 100,000 or more. The returns may be provisional ones to report such tax amounts as are calculated on a pro-rata monthly basis from the tax amounts for the preceding accounting period.

142. For individuals, the taxable year is the calendar year, and the tax return is due between February 16th and March 15th of the following year. There are no extensions of time.

143. A return is also filed for business occupancy taxes. Information relative to payroll, real property, and fixed assets taxes must be provided to appropriate government agencies. Capital gains taxes are to be included in the individual or corporate tax returns.

OTHER MATTERS OF IMPORTANCE

Distributable Profits

144. The Commercial Code provides that an amount equal to at least 10 percent of cash dividends be appropriated as a legal reserve until such reserve equals 25 percent of stated capital. The legal reserve and capital surplus are not available for dividends but may be used to reduce a deficit or may be transferred to stated capital.

145. If a *Kabushiki Kaisha* or a *Yugen Kaisha* has recorded deferred charges, the balance of which exceeds the sum of the balances of the legal reserve and capital surplus, the retained earnings equivalent to such excess may not be distributed.

Treasury Shares

146. The Commercial Code prohibits a *KK* or a *YK* from acquiring its own shares except in cases of redemption, merger, acquisition of business, exercise of lien and other rights and other limited cases. Acquired shares should be either canceled without delay or sold within a certain period.

Japanese Companies Following U.S. GAAP

147. When the preparation of consolidated financial statements became mandatory for listed and certain other companies in 1977, a certain number of companies had already been publishing consolidated financial statements that were prepared in accordance with U.S. GAAP in connection with sales of securities in overseas markets prior to 1977. The Ministry of Finance granted these companies the right to continue such practice. Individual financial statements of the companies comprising consolidated statements comply with Japanese GAAP.

APPENDIX A

Outstanding Auditing Pronouncements

By September 1987, the following translated titles of laws, ministerial ordinances, pronouncements and guidelines related to statutory audit requirements and auditing standards had been issued:

Laws

- *The Commercial Code*
- *The Commercial Code Special Measures Law Concerning Audit, Etc. of a Kabushiki Kaisha*
- *The Securities Transactions Law*
- *The Certified Public Accountant Law*

Ministerial Ordinances

- *The Ministry of Justice Ordinance Concerning Audit Reports of a Large-scale Corporation*
- *The Ministry of Finance Ordinance Concerning Audit of Financial Statements, Etc. and the Related Guidelines*
- *The Certified Public Accountant Law Implementation Order*

Pronouncements of the Business Accounting Deliberation Council

- *Auditing Standards*
- *Working Rules of Field Work*
- *Working Rules of Reporting*
- *Auditing Standards for Interim Financial Statements*

By September 1987, the following translated titles of statements, among others, had been issued by the Audit Committee and other bodies of the Japanese Institute of Certified Public Accountants:

No. 2 *Auditor's Report on Financial Statements Included in Initial Registration Statements*

No. 7 *Confirmation*

No. 8 *Observation*

No. 11 *Descriptions in the Scope Paragraph of the Auditor's Report Included in a Registration Statement*

1975	*Interpretation of "Principle of Consistency," "Special Reserves," Etc. in Conducting a Commercial Code Audit*
1976	*Descriptions in Auditor's Report on Audit Corporation of Relationship with Client*
No. 17	*Criteria for Determination of Materiality*
No. 25	*Use of the Work and Report of Other Auditors*
No. 26	*Standard Form of Auditor's Report on Consolidated Financial Statements*
No. 28	*Standard Form of Auditor's Report on Interim Financial Statements*
No. 40	*Auditor's Opinions in a Commercial Code Audit Report*
No. 41	*Standard Form of the Auditor's Report for a Commercial Code Audit*

APPENDIX B

Outstanding Accounting Pronouncements

By September 1987, the following translated titles of laws, ministerial ordinances, pronouncements and guidelines related to statutory accounting requirements and accounting standards had been issued:

Laws

- *The Commercial Code*
- *The Securities Transactions Law*
- *The Certified Public Accountant Law*

Ministerial Ordinances

- *The Ministry of Justice Ordinance Concerning Balance Sheet, Profit and Loss Statement, Business Report and Supporting Schedules of a Kabushiki Kaisha*
- *The Ministry of Finance Ordinance Concerning Financial Statements, Etc. and the Related Guidelines*
- *The Ministry of Finance Ordinance Concerning Consolidated Financial Statements and the Related Guidelines*
- *The Ministry of Finance Ordinance Concerning Interim Financial Statements and the Related Guidelines*

Pronouncements of the Business Accounting Deliberation Council

- *Financial Accounting Standards for Business Enterprises*
- *Financial Accounting Standards on Consolidated Financial Statements*
- *Cost Accounting Standards*
- *Accounting Standards for Foreign Currency Transactions, Etc.*
- *Financial Accounting Standards for Interim Financial Statements*
- *Opinions Relative to Foreign Currency Transactions and Liability for Retirement Allowances*

By September 1987, the following translated titles of statements, among others, had been issued by the Audit Committee and other bodies of the Japanese Institute of Certified Public Accountants:

No. 3 *Accounting for Depreciation*

No. 5 *Accounting for and Financial Statement Presentation of Reserve for Doubtful Receivables and Auditor's Opinion*

1968—20	*Changes in Accounting for Accrual of Certain Income and Expense Items*
1968–70	*Accounting for Reserve for Retirement Allowance*
1975	*Interpretation of "Principle of Consistency," "Special Reserves," Etc. in Conducting a Commercial Code Audit*
No. 20	*Changes in Accounting Principles and Procedures Due to Reasonable Cause*
No. 22	*Valuation of Investments in Common Stock and Advances to Subsidiaries or Affiliates*
No. 27	*Gain on Sale of Land or Equipment to Affiliated Companies*
No. 29	*Provisional Guidelines for Consolidated Financial Statements*
No. 31	*Provisional Guidelines for Interim Financial Statements*
No. 32	*Changes in Estimated Useful Lives of Depreciable Assets and Disclosure Thereof*
No. 33	*Accounting for and Disclosure of Adoption of a Qualified Pension Plan*
No. 34	*Bonuses to Employees*
No. 35	*Accounting for and Disclosure of Changes in Accounting for Liability for Retirement Allowance Due to Changes in Tax Law*
No. 36	*Consistency of Accounting Principles Between Interim Financial Statements and Annual Financial Statements*
No. 42	*Special Reserves Stipulated in the Special Taxation Measures Law and Other Laws for Regulated Industries*
No. 43	*Deferred Gain on Sale or Exchange of Certain Assets Authorized by Tax Laws*
No. 44	*Subsequent Events*
No. 45	*Accounting for and Disclosure of Income and Other Taxes*
No. 46	*Provisional Guidelines on Short-term Foreign Currency Receivables and Payables*
No. 47	*Disclosure of Additional Information*

APPENDIX C

Illustrative Auditors' Report and Financial Statements

The following financial statements are taken from the 1987 annual report of Hitachi, Ltd. and are not intended to include all information that Japanese law requires.

AUDITORS' REPORT
May 15, 1987

Mr. K. Mita, Director and President
Hitachi, Ltd.:

Century Audit Corporation

Y. Fukase, CPA (signed and sealed)
T. Saito, CPA (signed and sealed)
N. Watanabe, CPA (signed and sealed)

1. Scope of Audit

We have examined the balance sheet, the statement of income, the business report (limited to the matters concerning accounting), the appropriation of profit, and the supporting schedules (limited to the matters concerning accounting) of Hitachi, Ltd. for the 118th business year from April 1, 1986 to March 31, 1987 for the purpose of reporting under the provisions of Article 2 of the Commercial Code Special Measures Law Concerning Audit, Etc. of Kabushiki Kaisha. With respect to the aforementioned business report and the supporting schedules, our examination was limited to those matters based on the accounting records of the Company.

Our examination was made in accordance with generally accepted auditing standards and, accordingly, included the auditing procedures which should be performed customarily.

2. Result of Audit

In our opinion,

(1) the balance sheet and the statement of income present fairly the status of assets and profit and loss of the Company in conformity with laws, ordinances and the Articles of Incorporation of the Company,

(2) the business report (limited to matters concerning accounting), presents fairly the status of the Company in conformity with laws, ordinances and the Articles of Incorporation of the Company,

(3) the proposed appropriation of profit has been prepared in conformity with laws, ordinances and the Articles of Incorporation of the Company, and

(4) with respect to the supporting schedules (limited to the matters concerning accounting) there are none to be pointed out under the provisions of the Commercial Code.

3. Financial Interest

Neither the audit corporation nor the engagement partner has any financial or other interest in the Company required to be stated by the provisions of the Certified Public Accountant Law.

BALANCE SHEET
(As of March 31, 1987)

ASSETS	*AMOUNT*
(ASSETS)	*Yen (millions)*
CURRENT ASSETS	1,940,345
Quick Assets	1,355,495
Cash	536,642
Notes receivable	99,869
Accounts receivable	414,665
Marketable securities	192,613
Advances	79,121
Other quick assets	39,683
Reserve for doubtful accounts	Δ7,099
Inventories	584,849
Finished goods	90,927
Semi-finished goods	144,133
Raw materials	50,197
Work in process	299,591
FIXED ASSETS	742,209
Tangible fixed assets	402,101
Buildings	92,962
Structures	13,521
Machinery	143,898
Vehicles	437
Tools and furniture	116,427
Land	23,946
Construction in progress	10,906
Intangible fixed assets	4,371
Railway and public utility installation	795
Other intangible fixed assets	3,575
Investments	335,736
Stock of subsidiaries	119,357
Other securities	130,789
Long-term loans	69,985
Other investments	15,603
TOTAL	2,682,554

BALANCE SHEET *(cont.)*

LIABILITIES AND SHAREHOLDERS' EQUITY	*AMOUNT*
(LIABILITIES)	*Yen (millions)*
CURRENT LIABILITIES	1,272,982
Notes Payable	82,205
Accounts Payable—trade	268,821
Short-term bank loans	153,543
Accounts Payable—other	13,043
Accrued taxes	27,493
Accrued expenses	117,443
Advances from customers	427,219
Deposits from employees and others	76,082
Reserve for aftersale services	20,136
Other current liabilities	86,992
FIXED LIABILITIES	559,502
Debentures	313,873
Long-term loans	11,523
Retirement and severance indemnities	186,534
Reserve for loss of repurchasing computers	35,707
Provision for overseas investment loss	11,262
Reserve for exhibition at The International Garden and Greenery Exposition, 1990	600
TOTAL LIABILITIES	1,832,484
(SHAREHOLDERS' EQUITY)	
CAPITAL STOCK	141,228
LEGAL RESERVES	127,541
Capital surplus	92,339
Earned surplus reserve	35,202
RETAINED EARNINGS	581,299
Reserve for software program development	10,576
Earnings reserved for miscellaneous purposes	501,000
Unappropriated retained earnings at the end of the period	69,723
(Net income for the period)	(53,306)
TOTAL SHAREHOLDERS' EQUITY	850,070
TOTAL	2,682,554

NOTES TO BALANCE SHEET

NOTES

(1) Inventories are valued at the lower of cost or market based on the method below.

Finished goods, semi-finished goods and work in process. .	Identification cost method or moving average cost method
Raw materials.	Moving average cost method

(2) Securities are stated at:

Marketable securities	Lower of cost or market based on the moving average cost method
Other securities	Cost based on the moving average cost method

(3) Depreciation of tangible fixed assets is carried out by the declining balance method.

Accumulated depreciation of tangible fixed assets	¥903, 445 million

(4) Retirement and severance indemnities is computed pursuant to the retirement benefits policy of Hitachi, Ltd., and the balance is proportional to the retirement allowances payable at the end of the year.

(5)

Short-term credit to subsidiaries	¥305,586 million
Long-term credit to subsidiaries	¥ 43,413 million
Short-term debt from subsidiaries	¥144,854 million

(6) Other quick assets contain treasury stock of ¥17 million.

(7) Main assets denominated in foreign currency

. . . . .Securities	US $219,611 thousand

Main liabilities denominated in foreign currency

. . . . .Convertible debentures	US $ 68,873 thousand

(8) Assets mortgaged

Investment securities	¥ 295 million

(9)

Discount of notes receivable	¥55,189 million
Transfer by endorsement of notes receivable	¥20,768 million
Guarantees of loans	¥52,890 million

(10) Provision for overseas investment loss and reserve for exhibition at The International Garden and Greenery Exposition, 1990 is reserve established in accordance with Article 287-2 of the Commercial Code.

(11) Net Income per Share ¥18.92

STATEMENT OF INCOME
From April 1, 1986 to March 31, 1987

ORDINARY PROFIT AND LOSS	*Yen (millions)*	
Operating profit and loss		
Net sales		2,924,634
Cost of sales	2,299,891	
Selling, general and administrative expenses	540,111	2,840,003
Operating profit		84,631
Non-operating profit and loss		
Other income		
Interest and dividends received	64,044	
Others	9,817	73,862
Other deductions		
Interest and discount charges	24,417	
Others	45,537	69,955
Ordinary profit		88,538
EXTRAORDINARY PROFIT AND LOSS		
Extraordinary profit		
Profit from selling stock of a subsidiary	21,143	21,143
Extraordinary loss		
Loss from structural improvement of business	20,575	20,575
Income before income taxes		89,106
Corporation tax and resident tax		35,800
Net income for the period		53,306
Surplus profit carried over from the previous period		29,200
Interim dividends paid		12,659
Addition to earned surplus reserve		123
Unappropriated retained earnings at the end of the period		69,723

NOTES TO STATEMENT OF INCOME

NOTES

(1) Profit from selling stock of a subsidiary, ¥21,143 million is profit from sale of stock of Nippon Business Consultant Co., Ltd. at time of its listing on the Tokyo Stock Exchange.

(2) Loss from structural improvement of business, ¥20,575 million is writedown, abandonment, and loss of low-operating-rate production equipment for semiconductors, electron tubes and the like.

(3) Sales to subsidiaries during the period ¥1,246,328 million
Purchases from subsidiaries during the period ¥1,130,122 million

APPROPRIATION OF RETAINED EARNINGS

	Yen
Unappropriated retained earnings at the end of the period	69,723,490,343
Unappropriated retained earnings disposed of:	
Earned surplus reserve	104,378,300
Cash dividends ¥4.50 per share	12,673,162,274
Bonuses payable to Directors	160,000,000
Reserve for software program development	4,486,444,614
Earnings reserved for miscellaneous purposes	23,000,000,000
Unappropriated retained earnings carried forward to the following period	29,299,505,155

Note: An interim dividend of ¥4.50 per share was paid on December 10, 1986.

APPENDIX D

Checklist for Comparison of Generally Accepted Auditing Standards (GAAS) in the United States to Auditing Standards in Japan

General Questions	Answer	Comments
1. Is a primary purpose of an audit:		
a. to attest to information used by investors, creditors, and so forth?	No	
b. to satisfy statutory requirements (for example, the Companies Act)?	Yes	*1b.* For the Commercial Code and the Securities Transactions Law.
c. for tax purposes?	No	
2. A. The United States has ten generally accepted auditing standards including general standards, standards of field work, and standards of reporting. Those standards and their interpretations constitute U.S. generally accepted auditing standards which have been published in *Codification of Statements on Auditing Standards.* Do generally accepted auditing standards exist in your country?	Yes	2A. They are composed of ten Auditing Standards ("AS"), and *Working Rules of Field Work* ("WRFW") and *Working Rules of Reporting* ("WRR") issued by the Business Accounting Deliberation Council, which are supplemented by papers issued by the Audit Committee of JICPA ("ACP"). The Commercial Code, the Special Measures Law Concerning Audit, Etc. of a *Kabushiki Kaisha,* the Regulations Concerning Audit Report of a Large-scale Corporation (the

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
					Ministry of Justice), and the Ministerial Ordinance of Audit and Certification of Financial Statements, Etc. ("MOA") (the Ministry of Finance) also govern auditing.
B. If so, are they published?	Yes				
C. If auditing standards exist in your country, are they similar to U.S. standards?	Yes				2C. See comments on 2A.
D. If not, what are they?					
3. Who is responsible for promulgating auditing standards (for example, the profession, a governmental body, among others)?	See comments for question 2A				
4. Do auditors confirm receivables? (AU sec. 331)	Yes. WRFW II-1(3)-2 and 3, ACP7	✓			4. WRFW II-1(3)-2 and 4 require confirming notes receivable and loans receivable, if considered necessary.
5. Do auditors observe inventory counts? (AU sec. 331)	Yes. WRFW II-1(3)-6, ACP8	✓			
6. Do auditors receive written representations from management? (AU sec. 333)	No		✓		

Notes:

Checklist should be completed from the perspective of performing a local audit, *not* a referral audit.
AU numbers refer to sections in the *Codification of Statements on Auditing Standards,* unless otherwise noted.

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
7. Do auditors receive written representations from management's legal counsel? (AU sec. 337)	No		✓		7. WRFW II-1(3)-19 requires confirmation relative to subsequent events.
8. A. Do auditors prepare and maintain working papers? (AU sec. 339)	Yes. WRFW I-7	✓			
B. If so, do they include a written audit program outlining procedures to be performed? (AU sec. 339)	No	✓			8B. There is no explicit requirement.
9. Do auditors study existing internal controls as a basis for reliance thereon in determining the nature, extent, and timing of audit tests to be performed? (AU sec. 320)	Yes. AS II-1 WRFW I-3 II-1(1)-1,2	✓			
10. A. Do auditors communicate material weaknesses in internal accounting control to senior management or the client's board of directors? (AU sec. 323)	No		✓		
B. If so, is the communication documented? (AU sec. 323)			✓		
11. In obtaining evidential matter, does the auditor apply either statistical or nonstatistical procedures? (AU sec. 350)	Yes. AS II-2 WRFW I-3	✓			11. However, both AS and WRFW merely indicate that the work should be done on a test basis.

12. Is the auditor responsible for planning his examination to search for errors or irregularities that would have a material effect on the financial statements? (AU sec. 327)	Yes. AS II-3	✓	12. It requires taking into consideration materiality, relative risk, and other elements inherent in the items.
13. A. Does the auditor perform procedures to identify related party transactions and their effect on the financial statements? (AU sec. 334)	Yes. WRFW II-1(2)-11, (3)-20	✓	
B. If so, list the procedures.			13B. The auditor should— • Ascertain the propriety of accounting treatment accorded to transactions with related parties by requesting confirmations in writing on pertinent matters, and, when considered necessary, by visiting the related parties. • Ascertain the propriety of balances, collectibility and other of important accounts, such as sales, purchases, trade receivables, loans and investments. • Ascertain whether important liability accounts, such as trade payables, loans and other related party transactions are all recorded.

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
14. Does the auditor consider the adequacy of cut-off procedures to insure that movements into and out of inventories are properly identified in the accounting records? (AU sec. 313)	No	✓			
15. A. Are specific auditing procedures applied to transactions occurring after the balance sheet date? (AU sec. 560)	No	✓			15A. There is no explicit requirement as to specific procedures.
B. Are other auditing procedures applied to ascertain the occurrence of subsequent events that require adjustment to or disclosure in the financial statements? (AU sec. 560)	Yes. WRFW II-1(3)-19 and the related guideline	✓			
16. The concept of "joint auditors" in certain countries (for example, U.K., Canada, and Australia) is that two auditors or audit firms jointly audit the financial statements of a company and issue a single report signed by the two firms. This practice is not generally followed in the U.S. Does the concept of "joint auditors" exist in Japan?	No		✓		

17. When a principal auditor is reporting on financial statements that include one or more subsidiaries, divisions, branches, or investees: (AU sec. 543)			
A. Must the principal auditor assume responsibility for the work of the other auditor as it relates to the principal auditor's opinion?	No	✓	17A. Although WRR 2-(4) requires that reference be made in an audit report, it is understood that the principal auditor should assume responsibility for the work of other auditors.
B. May the principal auditor decide not to assume that responsibility by making reference to the other auditor and indicating the division of responsibility?	No	✓	17B. Although there are no explicit rules, it is understood that auditing standards do not allow reference to other auditors in the opinion paragraph of an audit report.
18. A. Is there a standard form of auditor's report? (AU sec. 509)	Yes. ACPs 2, 11, 26 and 41	✓	18A. For a Commercial Code audit—ACP 41. See also appendix C. For a Securities Transactions Law audit: Unconsolidated statements—ACPs 2, 11 Consolidated statements—ACP 26
B. List the circumstances that require a departure from the standard report and indicate the type of report required. (AU sec. 509)	MOA4, WRR III and IV ACPs 2 and 41		18B. See paragraph 49 of the text.

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
19. A. Does the auditor's report express an opinion on the consistency of application of accounting principles? (AU sec. 420)	Yes. MOA 4, WRR II(1)-2	✓			19A,B. In a Commercial Code audit, there is no requirement to refer to consistency unless there is an accounting change but the report does imply consistency exists. However, consistency has to be referred to in a Securities Transactions Law or other audit.
B. If not, does it imply that either consistency exists or the financial statements disclose the inconsistency?	See Comment				
20. A. Is the auditor's report dated as of the last day of fieldwork? (AU sec. 530)	No. WRR I	✓			
B. If not, what date is used?					20B. Date of preparation.
21. To express an opinion, must the auditor be independent? For the purpose of this checklist, independence is defined as being free of financial interest in the client. (Code of Professional Ethics, Rule 101)	Yes. CPA Law 24, 34-11 AS I-1	✓			21. See paragraph 8 of the text.
22. Please describe any standards for Japan for which there are no corresponding U.S. standards.					22. Auditing Standards for Interim Financial Statements (Statements issued by the Audit Committee and other bodies of the Japanese Institute of Certified Public Accountants):

1976	*Descriptions in Auditors' Report of Audit Corporation of Relationship with Client*
No. 17	*Criteria for Determination of Materiality*
No. 28	*Standard Form of Auditor's Report on Interim Financial Statements*
No. 40	*Auditor's Opinions in a Commercial Code Audit Report*
No. 41	*Standard Form of the Auditor's Report for a Commercial Code Audit*

APPENDIX E

Checklist for Comparison of Generally Accepted Accounting Principles (GAAP) in the United States to Accounting Principles in Japan

General Information	Answer	Comments
1. Are there generally accepted accounting principles in Japan? If so, are they codified?	Yes	
2. Who is responsible for promulgating accounting principles (for example, the profession, a governmental body, and so forth)?		2. The following are responsible for promulgating accounting principles: • The Commercial Code (CC) and the related ordinance (CCO). • Ministry of Finance (MOF) rules relative to parent-only financial statements (PR), consolidated financial statements (CR), and interim financial statements. Interim financial statements are applicable to the parent only. • The Business Accounting Deliberation Council to set up accounting standards (AS), cost accounting standards (CAS), accounting standards with respect to foreign

currency transactions (ASFC), and so forth and other standards, and to issue various opinions.

- The Audit Committee of the Japanese Institute of Certified Public Accountants (JICPA) to issue pronouncements on acceptable accounting practices by auditors through numerically sequenced papers (ACP). From time to time, other bodies of the JICPA have also issued pronouncements.

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
3. Are assets and liabilities recorded on the historical cost basis?	Yes. CC34	✓			
4. Are interest costs, incurred while activities that are necessary to get an asset ready for its intended use are in progress, capitalized as part of the historical cost of an asset? (I67)	No		✓		4. Only certain real estate development enterprises and trading companies capitalize interest as a business practice.
5. A. Is a general revaluation (either upward or downward) of assets permitted? (D40) B. If so, define the basis.	No. CC34, 285-2			✓	

Note:
Parenthetic references are to sections in the *FASB Current Text,* unless otherwise noted.

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
6. Are nonmonetary transactions that culminate an earnings process accounted for on the basis of the fair market value of the assets involved when that value is determinable within reasonable limits? (N35)	No	✓			
7. Is revenue recognized when it is earned and its realization is reasonably assured (rather than when money is received)? (Statement of Financial Accounting Concepts No. 5)	Yes. AS II-3B	✓			7. Immaterial earned income such as interest is recognized on a cash basis, as permitted by tax laws and JICPA pronouncement No. 68-20. The installment method is also acceptable (AS note 6).
8. Are costs recorded when incurred rather than when money is paid? (Statement of Financial Accounting Concepts No. 5)	Yes. AS II-1A	✓			8. Immaterial prepaid expenses such as interest, insurance, and rent are not recorded on an accrual basis, as permitted by tax laws and JICPA pronouncement No. 68-20.
9. A. Are consolidated financial statements required when one company has control over another company? (C51)	Yes. CR10 and 17. See Comment.		✓		9A. Consolidated financial statements are applicable only to companies whose securities are registered with the Ministry of Finance. MOF Ordinance

				with respect to registration of subscriptions and sales of securities (73-5, as amended) rules 10 and 17.
B. Is control usually indicated by ownership of over fifty percent of the outstanding voting shares? If not, how is control indicated?	Yes. CR5	✓		
10. A. Are there instances when an entity would not be consolidated even though control is present? (C51)	Yes. CR5		✓	
B. If so, list them.				10B. In case consolidation of a subsidiary would mislead readers. However, the fact that the nature of business of the subsidiary is significantly different from that of the parent company is not justification for not consolidating the subsidiary.
11. If consolidation is not otherwise appropriate, is the equity method used for unconsolidated subsidiaries, corporate joint ventures, and other investees, if the investments give the investor the ability to exercise significant influence over the investees' operating and financial policies? (I82)	Yes. CR10 See Comment.	✓		11. This answer is applicable only to consolidated financial statements. For the parent-company-only financials, the investments should be stated at cost or less.

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
12. Are there two methods of accounting for business combinations—the pooling-of-interests method and the purchase method? (B50)	No	✓			12. A business combination applies only to merger and consolidation. In such case, the pooling-of-interest method usually is adopted, *though* income statements are not combined on a retroactive basis. In case one or more enterprises become subsidiaries, the purchase method is applied generally.
13. Is the method used to account for a business combination disclosed? (B50)	No			✓	13. Cases are rather limited, and there is no specific requirement.
14. A. Do criteria exist for treatment of business combinations as poolings of interests? (B50)	No. See Comment.			✓	14A. Mergers and consolidations do not often take place in Japan, and accordingly, GAAP in this area are not specifically provided.
B. If so, list the criteria.					
15. A. Is goodwill arising from a business combination accounted for as an asset? (I60)	See Comment.		✓		15A. Goodwill may either be capitalized or charged to operations. If capitalized, it should be amortized within five years (CC285-7).

B. If so, is it amortized as a charge to income over the period estimated to be benefited?	No. CC285-7		✓	15B. CC285-7 stipulates that goodwill should be amortized within 5 years. It is regarded that the amortization period of 5 years would also apply to the excess of cost over underlying equity at acquisition dates of investments in subsidiaries when consolidated financials are prepared.
16. Are the following disclosures made for related party transactions: (R36)				
a. the nature of the relationship?	No		✓	
b. a description of the transactions for the periods presented?	No		✓	
c. the amounts of the transactions for the periods presented?	Yes. CCO40	✓		16*c*. Disclosures are required only of the amounts of business transactions between controlling interests and subsidiaries on a separate basis.
d. the amounts due to or from related parties at the balance sheet date?	Yes. CCO9 and 29	✓		16*d*. Disclosures are required only of the amounts due from and to controlling interests and subsidiaries on a separate basis, and directors and statutory auditors.

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
17. Is an estimated loss from a loss contingency accrued only if it is probable that an asset has been impaired or a liability incurred and the amount of loss can be reasonably estimated? (C59)	Yes. CC287-2 and AS note 18	✓			17. A loss is accrued in Japan if it is highly anticipated rather than "it is probable."
18. If a loss contingency is not accrued because both conditions for accrual listed in question 17 are not met, is disclosure of the contingency required when there is at least a reasonable possibility that a loss may have been incurred? (C59)	Yes. CCO32	✓			
19. Are guarantees of the indebtedness of others or other loss contingencies disclosed in financial statements even though the possibility of loss may be remote? [In the U.S., guarantees are usually disclosed as loss contingencies even if the possibility of loss is remote.] (C59)	Yes. CCO32	✓			
20. Are the following items disclosed in an enterprise's financial statements for each industry segment: (S20)					20. Segment information is not required to be disclosed.

a. Sales to outsiders and intersegment sales?	No		✓	
b. Operating profit or loss?	No		✓	
c. Identifiable assets and related depreciation, depletion, and amortization expense?	No		✓	
d. Capital expenditures?	No		✓	
e. Equity in net income and net assets of unconsolidated subsidiaries and other investees?	No		✓	
f. Effect of a change in accounting principle? (S20)	No		✓	
21. A. Are there any requirements to disclose the effects of inflation? (C27)	No			21A. In 1980, the Business Accounting Deliberation Council announced that it was too early to request enterprises to disclose the effects of inflation.
B. If so, list the disclosures required				
22. Are assets segregated into current and noncurrent classifications with a total for current assets presented? (B05)	Yes. CCO5	✓		
23. A. Are noncurrent assets those not expected to be realized within one year or the current operating cycle? (B05)	No. CCO7 and 8 See Comment.		✓	23A,B. The one-year rule is applied to nontrade accounts. Trade accounts are always regarded as current items.
B. If not, how are noncurrent assets defined?				
24. A. Is an allowance established for uncollectible receivables? (C59)	Yes. CC34	✓		

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
B. If so, what is the basis (for example, percentage of sales, aging of receivables, etc.) for calculating the allowance?					24B. Percentage of sales or receivables, identification of specific receivables, among others, are used for the basis of computation. Many companies use the allowable limit for tax purposes, which is computed based on net receivables. (ACR5)
25. Are receivables and payables, not arising in the normal course of business or subject to normal trade terms, recorded at an amount that takes imputed interest into account? (I69)	No		✓		
26. A. Is inventory stated at the lower of cost or market (or net realizable value)? (I78)	No. CC285-2		✓		
B. If not, how is inventory stated?	See Comment.	✓			26B. Basically cost. The lower of cost or market can also be used. If the cost method is adopted and the market is remarkably lower than the cost and is not expected to be recoverable, such inventory should be marked down to the market and charged to non-operating expenses or extraordinary loss. If the lower of cost or market method is adopted, devaluation of inventories to

				market should be charged to cost of sales or nonoperating loss. (AS note 10)
C. Is the basis disclosed?	Yes. CCO3	✓		26C. If the market is remarkably lower than the cost and the inventory is stated at cost, the fact should be disclosed (CCO 14).
27. Does cost for inventory purposes include: (I78)				
a. Materials?	Yes. CAS32 and other	✓		
b. Direct labor?	Yes. CAS32 and other	✓		
c. Factory overhead?	Yes. CAS33 and other	✓		
d. If the answer to *c.* is yes, is an allocable share of all factory overhead included?	Yes. CAS10, 30 and other	✓		
28. A. Are the following cost methods permitted for reporting purposes: (I78)				28A. The specific identified cost method and retail method are also acceptable. (AS note 21)
a. First-in, first-out (FIFO)?	Yes. AS note 21		✓	
b. Last-in, first-out (LIFO)?	Yes. AS note 21		✓	
c. Average cost?	Yes. AS note 21	✓		
B. Are the same methods permitted for tax purposes?	Yes	✓		
29. Is the inventory costing method used disclosed? (I78)	Yes. CCO3	✓		
30. A. Are fixed assets depreciated over their estimated useful lives by systematic charges to income? (D40)	Yes. CC34	✓		30A. Many companies use useful lives and rates prescribed by the tax regulations.

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
B. If so, is an accumulated depreciation account used?	Yes. CCO15	✓			30B. Fixed assets may also be stated at book value. In such case, accumulated depreciation should be disclosed.
31. Are disclosures made of: (D40)					
a. Depreciation expense for the period?	No			✓	31*a*. However, companies other than "small-scale companies" are required to prepare a schedule of fixed assets that contains a depreciation column.
b. Balances of major classes of depreciable assets?	Yes. CCO15	✓			
c. The methods used to compute depreciation for the major asset classes?	Yes. CCO3	✓			
d. Accumulated depreciation, either by major class of assets or in total?	Yes. CCO15	✓			
32. A. Do criteria exist for classifying leases as operating leases? (L10)	No			✓	32A. Most leases are accounted for as operating leases both by lessors and lessees. Tax regulations require that the following leases be accounted for as sales type leases: a. The lessee has a bargain purchase or renewal clause after the expiration of the lease term.

				b. Leased property is land, buildings, building auxiliary facilities and structures. c. Leased property is machinery and equipment made specifically for the lessee and cannot be leased to others. d. The leased property is scaffolding, which is difficult to identify due to the conditions of use. e. The lease term is less than 60 percent (70 percent if useful life is less than ten years) of the useful life stipulated by the tax regulations, and the lessee has a bargain purchase option.
B. If so, list the criteria and disclosure requirements.				
33. A. Do criteria exist for classifying leases as other than operating leases for the lessor and lessee? (L10)	No		✓	
B. If so, list the criteria, type of lease, and disclosure requirements.				
34. Are liabilities segregated into current and noncurrent classifications with a total for current liabilities presented? (B05)	Yes. CCO25	✓		

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
35. A. Are noncurrent liabilities those whose liquidation is not expected to require the use of current assets or the creation of current liabilities? (B05)	No. CCO27 and 28 See Comment.			✓	35A,B. Liabilities incurred through trade transactions are treated as current, and non-trade liabilities not expected to be due within one year are treated as noncurrent liabilities.
B. If not, how are noncurrent liabilities defined?					
36. For notes payable, is disclosure made of: (C59 and Statement of Financial Accounting Concepts No. 5)					
a. Interest rates?	No			✓	36*a*,*b*. Public companies are required to disclose by a schedule of long-term debt in an MOF report maturities and those bearing unusual interest rates or no interest.
b. Maturities?	No			✓	
c. Assets pledged as collateral?	Yes. CCO24-2	✓			
d. Covenants to reduce debt?	No			✓	
e. Minimum working capital requirements?	No			✓	
f. Dividend restrictions?	Yes. PR68	✓			

37. A.	For long-term construction-type contracts, are the percentage-of-completion and completed-contract methods used? (C04)	Yes. AS note 7	✓		
B.	If so, what are the criteria for determining the method to be used?				37B. Either method is adoptable at the option of the management.
38. A.	Are research costs charged to expense when incurred? (R50)	No. CC286-3	✓		38A. Research costs may either be capitalized or charged to operations. If capitalized, they should be amortized within five years.
B.	Are such costs disclosed?	Yes. PR86	✓		
39. A.	Are development costs charged to expense when incurred? (R50)	No. CC286-3	✓		39A. Development costs may either be capitalized or charged to operations. If capitalized, they should be amortized within five years.
B.	Are such costs disclosed?	Yes. PR86	✓		
40. A.	In the U.S., events and transactions are presented in the income statement as extraordinary items when they are unusual in nature and are of the type that would not reasonably be expected to recur in the foreseeable future. Do similar criteria for identifying extraordinary items exist in Japan? (I17)	No. CCO42		✓	

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
B. If not, what are the criteria?					40B. In Japan, extraordinary profit and loss include (1) prior period adjustments, (2) profit or loss on sale of fixed assets, including intangible assets and investments, and (3) other extraordinary profit or loss. Prior period adjustments consist of (1) adjustments of accumulated depreciation due to a change in useful lives or depreciation methods on a retroactive basis, (2) adjustments of over or underprovisions in prior periods, and (3) other adjustments related to expenses or revenue recorded in prior periods. Extraordinary items should be presented after ordinary profit or loss. (Guidance 160-2 relative to PR)
41. Are material events or transactions that are unusual in nature or expected to occur infrequently but not both (and thus do not meet the criteria for classification as extraordinary) shown as a separate component of income or expense? (I22)	No			✓	

42. A. Are disclosures required for:				
a. Extraordinary items? (I17)	Yes. CCO42	✓		42A,B. See comment on 40B.
b. Material events or transactions not classified as extraordinary items (I22)	No		✓	
c. Disposal of a segment of a business? (I13)	No		✓	
B. Indicate the financial statement presentation of these items.	See Comment.			
43. A. Are pension costs provided for covered employees over the term of employment? (P15)	Yes. AS opinion 2, and ACP 33 and 35	✓		43A.

42A,B. See comment on 40B. Disposal of a segment of business is not specifically required to be disclosed. However, it may have to be presented separately under the provisions described in 40B.

Ordinary profit (loss)		XXX
Extraordinary profit:		
Prior period adjustments	XXX	
Profit on sale of fixed assets	XXX	
Other	XXX	XXX
Extraordinary loss:		
Prior period adjustments	XXX	
Loss on sale of fixed assets	XXX	
Other	XXX	XXX
Profit (loss) before income taxes		XXX

43A. Many companies adopt unfunded retirement and severance benefit plans under which employees are entitled to lump-sum payments based on, in general, current rate of pay and length of service. Payment with respect to voluntary severance is less than the payment for involuntary severance and

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
					retirement. Provision is made in the financial statements by either of the following methods (Opinion 2 of the Business Accounting Deliberation Council): a. Full liability on a voluntary or involuntary basis. b. 40 or 50 percent of the liability on a voluntary basis. (Forty percent is the allowable limit for tax purposes, and 50 percent was the allowable limit before a revision of the tax law.) c. Actuarially computed present value of the liability under the plan.
B. If so, do they include charges for costs assigned under the actuarial method used to years prior to the plan's inception?	No. AS opinion 2	✓			43B. Opinion 2 requires "in principle" to charge prior service costs to current operations. However, it allowed adoption of a guidance contrary to the "principle." JICPA allows amortization of the prior service costs resulting from an accounting change in five years on a systematic basis. (JICPA pronouncement 73-91)

44. A. Are specific disclosures required relating to pension plans? (P15)	No		✓	
B. If so, list them.				
45. A. When accounting income and taxable income differ, are deferred income taxes recorded for differences (as opposed to permanent differences)? (I24)	No See Comment.	✓		45A. Deferred tax accounting may be adopted only when consolidated financial statements are prepared.
B. If so, are deferred taxes provided for all timing differences (as opposed to only those meeting certain criteria)?	See Comment.			45B. Either partial allocation or comprehensive allocation can be adopted.
C. If deferred taxes are provided only for those timing differences meeting certain criteria, what are the criteria?	See Comment on 45B.			
46. A. Are deferred taxes determined on the basis of tax rates in effect at the time the difference originated? (I24)	See Comments.			46A,B. Either the deferral method or liability method can be adopted.
B. If not, on what basis?				
47. A. Is specific information related to income taxes required to be disclosed? (I28)	No		✓	
B. If so, list the requirements.				
48. A. Are operating losses reported on the income tax return allowed to be carried backward to earlier periods? (I37)	No		✓	

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncement	Predominant Practice	Minority Practice	Not Done	Comments
B. If so, are the tax effects of a loss carryforward included in the income in the period?					
49. A. Are operating losses reported on the income tax return allowed to be carried forward? (I37)	Yes. Corporation Tax Law 57	✓			49A. Permitted for the companies that file "blue form" tax returns.
B. If so, are the tax effects of a loss carryforward included in the income in the period realized?	Yes. ACP 45	✓			49B. Income taxes should consist of the amounts currently payable that are net of the tax effect of a loss brought forward.
50. Are financial statements of a foreign entity prepared for consolidation purposes measured in the currency of the primary economic environment in which the entity operates? (F60)	No. ASFC III			✓	
51. Are all elements of financial statements translated at current exchange rates? (F60)	No. ASFC III			✓	51. See paragraphs 91 through 92 of the text.
52. A. Are translation adjustments reported separately? (F60)	Yes. CR40 See Comment.	✓			52. See paragraphs 91 through 92 of the text.
B. Are they accumulated in a separate component of stockholders' equity until ultimately realized?	No. CR40			✓	

C. Is there an analysis of the changes during the period in the component of stockholders' equity relating to translation adjustments?	No			✓	
53. A. Are gains and losses resulting from transactions, denominated in a currency other than that of the environment in which the entity operates, included in determining net income for the period in which the exchange rate changes? (F60)	Yes. ASFC I-2(2)	✓			53A. See paragraphs 91 through 92 in the text.
B. Is the aggregate transaction gain or loss included in determining net income for the period disclosed in the financial statements or notes?	No		✓		53B. Not specifically required.
54. Are gains or losses on foreign currency transactions that are intended to hedge a foreign currency commitment deferred and included in the related transaction? (F60)	Yes. For noncurrent items, ASFC note 4-2	✓			54. Current receivables and payables denominated in foreign currencies that are covered by forward exchange contracts are translated at the forward contract rates.
55. What information is disclosed about foreign currency restrictions?				✓	
56. Are significant events arising subsequent to the balance sheet date reflected in the financial statements or notes thereto?	Yes. CCO45, PR8-4	✓			

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57. Please list any standards for Japan for which there are no corresponding U.S. standards.					57. Statements issued by the Audit Committee and other bodies of the Japanese Institute of Certified Public Accountants for which there are no corresponding U.S. standards: 1968-20 *Changes in Accounting for Accrual of Certain Income and Expense Items* 1975 *Interpretation of "Principle of Consistency," "Special Reserves, Etc." in Conducting a Commercial Code Audit* No. 22 *Valuation of Investments in Common Stock and Advances to Subsidiaries or Affiliates* No. 27 *Gain on Sale of Land or Equipment to Affiliated Companies*

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