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Accounting Profession in Japan, Second Edition Revised; Professional Accounting in Foreign Country Series

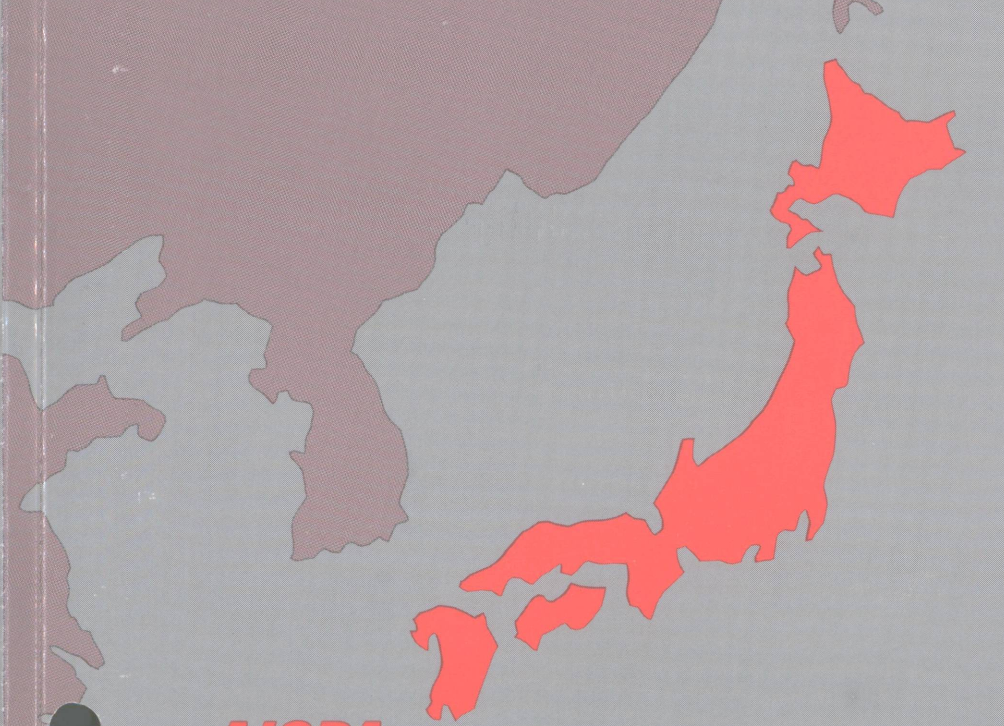
KPMG Century Audit Corporation

Steven F. Moliterno

SECOND EDITION, REVISED

The Accounting Profession in Japan

PROFESSIONAL ACCOUNTING IN FOREIGN COUNTRIES SERIES



AICPA
American Institute of Certified Public Accountants

The Accounting Profession in Japan Second Edition, Revised
PROFESSIONAL ACCOUNTING IN FOREIGN COUNTRIES SERIES
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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 Howard Keefe, Harvey Moskowitz, James Flynn, Susan Sgromo, and the accounting firms of Arthur Andersen & Co. and Coopers & Lybrand. The committee would also like to acknowledge the fine editorial efforts of Carrie Vaccaro and Gina Goldstein and the production work of Robert DiCorcia, Jeanmarie Brusati, and Joyce Kehl.

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Prepared by

KPMG Century Audit Corporation

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Series Editor

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Preface

This booklet is one of a series on professional accounting in foreign countries. The material is current as of May 31, 1991. Changes after this date in the standards of either the United States or Japan may alter the comparisons and references 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 from those of the United States.

John F. Hudson
Vice President—Technical
Standards and Services

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: the tax practitioner and the certified public accountant. The term *tax practitioner* may be used only by members of the Japan Association of Tax Practitioners (the Association); *certified public accountant* (CPA) may be used only by members of the Japanese Institute of Certified Public Accountants (JICPA, or the Institute), which can be reached at the following address:

> Japanese Institute of Certified Public Accountants
> 5–18–3, Hongo 5 chome
> Bunkyo-Ku
> Tokyo 113, Japan

Tax practitioners perform professional services that include the preparation of tax returns and consultations relating to tax matters for business enterprises and individuals. CPAs examine and report on the financial statements of third parties. The Association and the Institute admit new members who have passed the required examination(s) or who have the required qualifications and are not legally restricted (for example by age or illegal activity). In addition, both the Association and the Institute control the 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 companies listed on Japanese stock exchanges, and unlisted companies that have issued new shares or bonds in the amount of yen 500 million or more to the public, file with the Ministry of Finance (MOF) annual and semiannual reports, including financial statements with audit reports signed by independent auditors. Such an 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.

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

Foreign Reciprocity

4. Only tax practitioners and CPAs qualified in Japan are permitted to perform professional services. An individual with overseas qualifications is 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. 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 Financial Accounting Standards for Business Enterprises and standards relating to consolidated financial statements, cost accounting, and translation of foreign currency transactions. The Council has also issued auditing standards, including working rules of fieldwork and reporting.

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

7. After approval was obtained from the Council, the audit and other committees 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 other 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 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 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. JICPA Disciplinary Rules include ethics restrictions for personal relationships with client personnel, a beneficial interest in a client, and competition with other CPAs based on fees. For example, there is no restriction regarding the proportion of total fees generated from one client. Additionally, the JICPA does not allow its members to advertise their skills, experience, 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 not required 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 must then acquire 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 practicing CPA's duties.

Rights of Membership

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

Number of Members

13. The JICPA consisted of the following members as of May 31, 1991:

CPAs	9,046
Foreign CPAs	17
Audit corporations	114
Junior CPAs	2,147
Total	11,324

CPE Requirements

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

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Auditing Requirements

STATUTORY AUDITING AND REPORTING REQUIREMENTS

15. There are two types of statutory audit requirements: the Commercial Code and 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 must 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* to elect one or more statutory auditors at a general meeting of stockholders.

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 proposals and documents that directors propose to submit to the general meeting of stockholders
c. Request that directors cease unlawful acts, if applicable
d. Submission of an audit report on the balance sheet, income statement, business report, proposal of appropriation of retained earnings, 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 a limited-liability corporation, or YK) is limited to items *b* and *d* above. A YK is not required to appoint a statutory auditor unless such a requirement is specified in the Articles of Incorporation. Neither a *Gomei Kaisha* (unlimited-liability corporation) nor a *Goshi Kaisha* (corporation with general- and limited-liability partners) is required to appoint a statutory auditor.

19. A KK with a stated capital of yen 500 million or more, or with total liabilities of yen 20 billion or more, 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 independent auditors who are either independent CPAs or audit corporations.

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

21. The independent auditor is elected at a general meeting of stockholders. The term of office of an independent auditor ends on the day of the annual general meeting of stockholders for the fiscal year in which the independent auditor served. The term of office is automatically extended unless a contrary resolution is made by the stockholders.

22. The stockholders can dismiss the independent auditor at any time by a resolution made at the general meeting of stockholders. In certain instances, such as when negligence or violation of the rules of performance of professional duties is involved, the independent auditor may be dismissed by the common consent of the statutory auditors. In such cases, the statutory auditors must report the dismissal and its cause to stockholders at the first general meeting following the dismissal, during which the independent auditor has the right to express his or her opinion regarding the dismissal.

23. Directors of a KK and a YK should prepare the balance sheet, income statement, business report, and proposal of appropriation of retained earnings.[1] A KK other than a small-scale or a large-scale

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[1]The business report must contain certain information related to the company's operations, such as a description of the business, its financial condition, capital expenditures, names of its directors and statutory auditors, and major shareholders and creditors.

corporation (a medium-scale corporation) should submit this information to the statutory auditors at least seven weeks 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. 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 contain the following:

a. Outline of audit procedures employed

b. Statement as to whether the contents of the balance sheet and income statement agree with the related accounting records

c. Statement that the contents of the balance sheet and income statement comply with laws, regulations, and articles of incorporation, if applicable

d. Statement that the contents of the balance sheet and income statement do not comply with laws, regulations, and articles of incorporation, if applicable, and the reason for the discrepancy

e. Statement as to whether any change in accounting principles is reasonable

f. Statement as to whether the contents of the business report comply with laws, regulations, and articles of incorporation

g. Statement as to whether the proposal of appropriation of retained earnings complies with laws, regulations, and articles of incorporation

h. Statement that the proposal of appropriation of retained earnings is significantly improper, if applicable

i. Statement as to whether the supporting schedules include all required information, and whether such information is proper

j. Statement describing any unjust acts that have occurred or anything unlawful about a director's performance of duties, if applicable

k. Statement of disclaimer, if the examination could not be performed satisfactorily

24. Directors of a small-scale corporation and, if applicable, a YK should submit the financial statements and business report to statutory auditors at least five weeks 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 receipt of the financial statements and business report. 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 paragraph 23.

25. For a large-scale corporation, statutory auditors and the independent auditor are to receive the financial statements and business report at least eight weeks before the general meeting of stockholders and the supporting schedules within three weeks later.

26. The independent 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* (see paragraph 23). (The independent auditor must report on matters concerning accounting for items *f* and *i*.) Within one week after receiving the independent auditor's report, the statutory auditors should submit to the directors an audit report that contains the following:

a. If applicable, a statement that the procedures or conclusions of the independent auditor are considered not appropriate, including the reason and a description of the statutory auditors' procedures or conclusions

b. Items *h*, *j*, and *k* and nonaccounting portions of items *f* and *i* (see paragraph 23)

c. Outline of audit procedures employed relative to item *b* (see paragraph 23)

27. The independent auditor is not required to examine the conduct of the directors. However, if anything unlawful about a director's performance of duties is noted during the normal course of the examination, the independent auditor must report that fact to the statutory auditors.

Securities Transactions Law Audit

28. The purpose of the Securities Transactions Law is to require an audit of the financial statements and supporting schedules included in a registration statement or in an annual or semiannual report filed with the MOF, in order to protect existing and prospective investors.

29. The following are required to file the statements or report referred to in paragraph 28 with the MOF:

a. A corporation or certain shareholders of a corporation that plans to sell to the public the corporation's new or outstanding equity or debt securities aggregating yen 500 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 or in an annual report should be accompanied by an audit report issued by a CPA in accordance with the 1957 MOF Ordinance No. 12, *Audit of Financial Statements and Related Guidelines*, as amended. Semiannual financial statements for public companies must be submitted to the MOF. These statements require a limited audit, in which certain auditing procedures (for example, confirmations) can be omitted. 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 and for Securities Transactions Law purposes substantially overlaps, a normal procedure for a corporation subject to both audit requirements is to have the independent 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 parent-company-only financial statements (individual financial statements) and consolidated financial statements should contain the following items:

a. Outline of the audit, which should state—
   - The scope of the financial statements
   - Whether the audit was performed in accordance with generally accepted auditing standards
   - Whether auditing procedures normally considered necessary were performed (If important audit procedures normally considered necessary were not performed, this fact and the reason for it should be disclosed.)

b. Opinion as to whether the audited financial statements and supporting schedules fairly state the financial position and results of operations, including—

- Whether the accounting principles and procedures employed by the corporation are in conformity with generally accepted accounting principles and are 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. Information regarding material contingencies and subsequent events

33. For a semiannual audit report, the requirements 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 as to whether the interim financial statements present useful accounting information relative to the semiannual period constituting 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 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. Japanese auditing standards consist of four general standards, three fieldwork standards, and four reporting standards, corresponding 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 the *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, among others. (See appendix D for a 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. Like those in the United States, Japanese general standards require that an auditor be independent and that an auditor not, without justification, 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 from providing 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 United States 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 Fieldwork.

41. The Working Rules of Fieldwork are composed of general and customary auditing procedures; the latter are divided into those related to individual financial statements and consolidated financial statements. The working rules for customary procedures related to individual statements cover auditing procedures for preliminary review, transaction records, and financial statement items. The working rules for customary procedures related to consolidated statements cover auditing procedures for preliminary review, basic matters, 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 contingent liabilities and subsequent events.
- Currently, there are no working rules or guidelines requiring the auditor to give consideration to a question concerning an entity's going concerns.

Standards of Reporting

43. The standards of reporting specify the following:

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

b. In expressing an opinion on the financial statements, the auditor must state either that the financial statements examined present fairly the financial position and results of operation of the enterprise (a fair opinion) or that they do not (an adverse opinion). (See paragraph 48*b* regarding important exceptions.)

c. The auditor should disclaim an opinion on the financial statements when he or she has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.

d. In his or her report, the auditor should disclose important items (such as contingencies or subsequent events) considered necessary to prevent the financial statements from being misleading.

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*) contingencies and subsequent events.

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

46. There are significant differences in the reporting area between Japanese and U.S. auditing standards. In Japan—

- Reference to other auditors cannot be made because no division of responsibility is permitted with reference to other auditors in the opinion paragraph.

- There is no requirement that an auditor's report cover the financial statements both of the current period and of one or more prior periods presented on a comparative basis. If a report is required for a prior year, a copy of the prior year report is attached to the current year report.
- Auditing standards require an opinion of whether the form and content of the financial statements comply with either generally accepted standards or with the related regulations concerning the 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 qualified opinions, except those regarding consistency, should not be issued either for Securities Transactions Law audit purposes or for Commercial Code audit purposes.
- The CPA Law requires the audit report contain a statement as to whether the reporting auditor has any relationship, as specified, with the client.

Standard Form of Reports

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

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

b. Auditor's reports on individual 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 when a disclaimer or adverse opinion is to be issued.

Qualifications in Audit Reports

48. Based on the Working Rules of Reporting and various regulations, guidelines, and the Audit Committee papers, a summary of qualifications includes—

a. Scope limitations, which are referred to and described in the scope paragraph.

b. Important exceptions, which are disclosed in the opinion paragraph. In the event of such an exception, no overall opinion should be expressed in a Commercial Code audit. For Securities Transactions Law purposes, if the exception is not considered so serious that the financial statements as a whole are not presented fairly, a "fair" opinion is to be given; otherwise, an adverse opinion is to be given.

c. Inconsistency (concurred in), to which reference is made in the opinion paragraph. Under both the Commercial Code and the Securities Transactions Law, the reason for concurrence also should be given in the opinion paragraph.

d. Inconsistency (not concurred in), which receives the same treatment as important exceptions.

e. Uncertainty, regarding which an explanatory paragraph is added to an unqualified opinion; 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. Audit procedures continue up to the date of the audit report. The practice of dual dating for subsequent events, accordingly, does not exist in Japan.

Other Auditors

50. In May 1991, the reporting standards were changed regarding the work of other auditors. A principal auditor can no longer make reference to the work of other auditors. This change was made to emphasize the complete responsibility assumed by the principal auditor.

51. The concept exists in Japan of a joint audit, 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. The Code stipulates the financial reports that are to be prepared and states 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 general standards, income statement standards, and balance sheet standards and are supplemented by twenty-five notes. In addition, the Council has issued separate 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 has issued a number of statements on accounting practices acceptable for independent auditors to follow in expressing their opinion on financial statements. Periodically, the JICPA itself has issued pronouncements to guide independent auditors in the handling of 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 writedowns of assets are acceptable for tax purposes, if recorded on the books of account; Japanese tax authorities have issued comprehensive regulations on accounting practices acceptable for tax purposes. These tax regulations have significantly influenced the selection of accounting practices by Japanese companies. Many companies tend to follow tax laws and regulations for accounting issues, 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, an income statement, a business report, and a proposal of appropriation of retained earnings, 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 auditor's opinion, are to accompany any notice to stockholders of a stockholders' general meeting. The original documents are retained at the head office for five years and copies are maintained at branch offices of the company for three years for inspection by stockholders and creditors. The balance sheet, income statement, and proposal of appropriation of retained earnings are to be approved by the stockholders at a general meeting. If an independent auditor examines the financial statements under the Commercial Code requirements, the financial statements (except for the proposal of appropriation of retained earnings) are finalized upon issuance of an unqualified opinion by the independent auditor and upon agreement of the statutory auditors with the independent auditor's opinion. After obtaining approval of the financial statements by the stockholders at a stockholders' general meeting, the directors shall give public notice of the balance sheet (and of the income statement, in the case of a large-scale corporation).

57. Under the Securities Transactions Law, Japanese companies that are listed on securities exchanges or have sold securities to the public in the amount of at least yen 500 million are required to file an annual report with the MOF within three months of the end of a fiscal

year (and after the stockholders' general meeting is held and the financial statements are approved). This annual report should include, among other data, the balance sheet, income statement, and statement of appropriation of retained earnings for the current and previous fiscal years, and schedules of certain accounts and transactions for the current year.

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

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; 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 under the Commercial Code into capital stock, legal reserves, and retained earnings or, under the Securities Transactions Law, into capital stock, capital surplus, legal reserve retained from earnings, and retained earnings.

61. The income statement should be divided into ordinary income and extraordinary gain or loss. Ordinary income should be subdivided into operating income and nonoperating profit and loss. Extraordinary gain or loss includes—

a. Prior period adjustments.

b. Gain or loss on sales of fixed assets, including intangible assets and investments.

c. Other extraordinary gains and losses.

After extraordinary gains or losses have been added to ordinary income (or loss), income (or loss) before income taxes should be shown, and net income (or loss) should be presented after deduction of income taxes. Unappropriated retained earnings brought forward, interim dividend and related transfer to legal reserve retained from earnings, and reversal of certain reserves, if any, are added to or deducted from net income (or loss), 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 not required for small-scale corporations.

63. Neither the Commercial Code nor the Securities Transactions Law requires a statement of cash flows as a basic financial statement. However, similar cash flow information is included as supplemental information to the annual report filed with the MOF under the Securities Transactions Law.

Types of Statements Prepared

64. Under the Commercial Code, the statements and supporting schedules should be prepared on a parent-company-only basis. Effective January 1989, a KK that is not a small-scale corporation is required to disclose in a business report consolidated sales and net income or aggregated amounts of sales and net income of material subsidiaries. There is no requirement that they be presented on a comparative basis.

65. The Securities Transactions Law prescribes that annual individual financial statements and consolidated financial statements, if applicable, as well as semiannual financial statements (individual only), be filed with the MOF together with other data. The terminology, forms, and methods of preparation of consolidated and interim financial statements are prescribed by the 1976 MOF Ordinance No. 28, *Regulations Concerning Consolidated Financial Statements*, and by the 1977 MOF Ordinance No. 38, *Regulations Concerning Interim Financial Statements*, both as amended. The related ordinances require that the individual 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 they comprise (*a*) balance sheet,

(*b*) income statement, and (*c*) statement of retained earnings. The consolidated income statement ends with net income (or loss) and is combined with the consolidated statement of retained earnings.

67. The semiannual statements consist of a balance sheet and income statement. The balance sheet as of the corresponding date of the prior year and the latest year-end, and the income statement for the corresponding period of the prior year, should also be presented.

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, except when market is significantly less than cost and is not expected to recover, in which case they must be valued at market. Fixed tangible assets should be stated at cost less accumulated depreciation. When unexpected impairment of their value occurs, they should be written down as a charge against income.

69. Receivables should be stated net of allowance for doubtful receivables.

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

Marketable Securities

71. Temporarily owned marketable debt and equity securities can be carried at either 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, but they should be written down to reflect any permanent decline in value by a corresponding charge against income.

Inventories

72. Japanese companies may value inventories at cost (except when market is significantly less than cost and is not expected to recover, in which case they must value such inventories at market) or

at the lower of cost or market. The last-purchase-cost method (which values inventories at the most recent purchase price prior to a company's year-end) 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 that practice as long as it does not distort periodic income.

Allowance for Doubtful Receivables

74. Under the tax laws, a general bad-debt provision calculated on the basis of 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, states 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 an amount is not less than that 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 individual 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. Investments in unconsolidated subsidiaries and affiliates (20–50 percent-owned companies) are accounted for by the equity method.

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 (until maturity of bonds). Stock issue expenses may not be charged to additional paid-in capital.

77. Goodwill may be recorded as an intangible asset only through a purchase of a group of assets or an entire business, or through

merger and consolidation. Research and development expenses permitted to be capitalized are limited to expenditures related to (*a*) research for new products and techniques, (*b*) adoption of new techniques and 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, in general, on current rate of pay and length of service at the time of termination. In the past, the plans were generally not funded, but there is now a tendency to fund them partially.

79. Tax regulations limit the deductibility of 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. Business Deliberation Council Opinion 2, *Establishment of Liability for Retirement Allowance*, supplemented by JICPA pronouncements and Audit Committee papers, states 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 to use another method. Accordingly, a company chooses one of these methods after taking various factors into consideration.

80. There are several annuity-type pensions that differ according to the size of the employer, the pension participants, or the method of payment of future pensions. Contributions to the pension fund are tax deductible for those plans that meet the requirements of tax regulations. Most large companies have adopted such pension plans to obtain the maximum tax benefit. Contributions, including past service costs to the pension fund, are charged to income as incurred. Pension costs related to past service are amortized and funded over a reasonable period of time.

Installment Sales

81. Revenue from installment sales should be recognized when the goods are delivered. However, acknowledging that uncertainties exist

with respect 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 as long as a company records sales on that basis in the books of account; therefore, many companies record sales on the installment basis.

Leases

82. No authoritative accounting literature has been issued with respect to leases. Most leases are accounted for by both lessors and lessees as operating leases. Effective January 1989, a KK is required to disclose in a footnote to the financial statements material fixed assets used, which are treated as an operating lease. Due to an increase in the financial lease business, the tax authorities issued a regulation in 1978 requiring that leases be accounted for as sales- and purchase-type leases in the following circumstances:

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

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

c. Leased property is machinery and equipment made specifically for the lessee that 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 of the useful life stipulated by the tax regulations (less than 70 percent if the useful life is less than ten years), and the lessee has a bargain purchase option.

Interest Cost

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

Income Taxes

84. Income tax expense shown in individual 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, taxes levied by local governments, and income tax on interest and dividend income withheld at the source. Business

tax is also levied based on income, but not on electric power companies, gas companies, and life and casualty insurance companies. The MOF requires that the business tax be included in selling, general, and administrative expenses. Audit Committee Paper No. 45 agrees with the classification "in principle."

85. 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.

86. 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 not considered acceptable in Japan in the preparation of individual financial statements. However, this concept may be used in the preparation of consolidated financial statements. Deferred taxes may be provided for either the partial basis or for all timing differences.

Bonuses to Directors

87. Bonuses to directors 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

88. A dividend is payable with the approval of stockholders of the proposed appropriation of retained earnings, and accordingly, the amount of a proposed dividend is included in unappropriated retained earnings in the balance sheet. The board of directors may declare the payment once a year of an interim dividend from unappropriated retained earnings brought forward (payment from current earnings is not permissible). Such an interim dividend is also not reflected on the interim balance sheet until the resolution is made.

89. The Commercial Code provides that a company may transfer legal reserves to a capital stock account with the approval of the board of directors. Effective April 1991, a company may, upon approval by its shareholders, transfer unappropriated retained earnings to the capital stock account without issuing any shares.

90. The gross proceeds from the sale of new shares or the aggregate 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. 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

91. 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. However, if there has been a significant change in exchange rates, the long-term 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 purposes of translation in subsequent financial statements. If there is a forward exchange contract for hedging relative to a current asset or liability item, such an 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.

92. Resulting gains or losses from 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 used by the head office.

b. Nonmonetary assets, 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 those described in *b* are translated at historical rates or average rates.

d. Resulting translation difference is charged or credited to operations.

93. The financial statements of foreign subsidiaries and affiliated companies are translated into Japanese yen for preparation of consolidated financial statements 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 those described in *a* 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 and as a "translation difference."

Accounting Changes

94. The accounting principles adopted by a company should not be changed without good reason. If a change in accounting principles is made, disclosures are required regarding the fact of, the reason for, and the effect of the change. Presentation of the cumulative effect of the accounting change is not explicitly required on the income statement, and no disclosure is required as to pro forma effects of the change. A retroactive restatement of financial statements is normally not made.

Business Combinations

95. No authoritative literature exists regarding acquisitions and mergers. In practice, acquisition of an entity is regarded as an investment in the entity. Such a transaction does not affect the financial statements of the acquired entity, and no push-down accounting takes place. On the investor's books, the investment is recorded at cost, and no cost-over-equity problem arises, other than for consolidation purposes. Mergers usually occur by an exchange of shares of the acquired company with those of the acquiring company (possibly with a certain amount of money involved). Mergers are generally accounted for by the pooling-of-interest method.

Futures Contracts

96. A debt securities futures exchange was established in 1985, and the JICPA issued a pronouncement stating that profit and loss on a futures transaction on debt securities should 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

97. Real estate transactions have not been given much attention, and thus no pronouncements have been issued to date regarding them.

Other Matters

98. 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 differences in business environment. (See appendix E for a 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

99. Effective for fiscal years beginning on or after April 1, 1990, an annual report to the MOF shall include disaggregated information about the enterprise's operations on a consolidated basis in different industries and geographic locations, and about overseas sales. For each industry and geographic segment, companies shall disclose information on (*a*) external sales and intersegment sales, (*b*) operating expenses, and (*c*) operating income (loss). Overseas sales consist of export external sales of domestic operations and external sales of overseas operations. Disclosure of sales to major customers is not required.

Disclosures About Market Value of Financial Instruments

100. Effective for fiscal years ending on or after March 31, 1991, companies filing their annual reports with the MOF shall disclose the following information in tabular form:

a. Marketable securities and option premiums—carrying and market value at the balance-sheet date and the resulting unrealized gain or loss

b. Futures—outstanding contract amount and market value of contract at the balance-sheet date and the resulting unrealized gain or loss

4

Business Environment

FORMS OF BUSINESS ORGANIZATION

101. Two forms of business organization exist in Japan: the individual proprietorship and the company. A partnership is not a recognized legal entity, although companies recognized under the Japanese Commercial Code as the *Gomei Kaisha* and the *Goshi Kaisha* are in substance similar to the partnership in the United States. Regardless of the form of business organization, the Commercial Code requires that it maintain books of account and prepare a balance sheet at least once a year.

Entities With Corporate Attributes

102. The Japanese Commercial Code provides that a company may be registered as one of the following:

a. *Kabushiki Kaisha* (KK), in which the liability of a shareholder is limited to the amount of his or her shareholding. The majority of businesses are formed as KKs. Effective April 1, 1991, a KK is required to have a capital amount of at least yen 10 million.
b. *Gomei Kaisha*, composed of members with unlimited liability.
c. *Goshi Kaisha*, composed of some members with unlimited liability and others with limited liability.

103. Another form of business organization is a limited company called a *Yugen Kaisha* (YK), which is incorporated under special statute. A YK is normally formed by a small or closely held business. Effective April 1, 1991, a YK is required to have a minimum capital amount of yen 3 million.

104. KKs and YKs must hold ordinary general shareholders' meetings 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 trustee (when the company is liquidating) and, in the case of a KK, by shareholders whose shares represent 3 percent or more of the total shares issued during the last six months. The resolution for a general meeting shall be sought only for matters provided for in the Commercial Code or the articles of incorporation.

105. If there are shares not paid for after the company is formed, 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 the capital increase, directors are jointly liable for subscription to those shares.

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

107. Directors' duties include the following:

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

108. 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.

109. The Commercial Code provides that the amounts of additional paid-in capital, and of capital surplus from reduction in capital stock and merger, be set aside as capital surplus reserves. The Commercial Code also provides that an amount equivalent to at least 10 percent of cash dividends and officers' bonuses be set aside as a legal reserve

until the reserve equals 25 percent of stated capital. Both reserves may be used to reduce a deficit, or they may be transferred to stated capital.

Branch of a Foreign Company

110. 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, establish an office, and give public notice relative to the office, the law on the basis of which the company was organized, and the name and address of the representative of the company in Japan.

111. A foreign company that has established a branch in Japan is deemed to be a company of the same type as the Japanese company it most closely resembles. Accordingly, the responsibilities and liabilities of the branch of a foreign entity are the same as those of Japanese companies.

112. The head office in the foreign country that has established a branch in Japan should take full responsibility for the commercial activities and the representative of the branch.

Partnership Entities

113. There is no recognized form of business organization in Japan comparable to the U.S. partnership. However, organizations such as the *Tokumei Kumiai* (undisclosed association), the *Gomei Kaisha*, and the *Goshi Kaisha* are somewhat similar to the U.S. partnership.

114. A contract of undisclosed association is formed when the parties agree that an undisclosed party shall make a contribution toward the business, and all parties shall divide any profit that arises from the 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.

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

116. A member of a *Gomei Kaisha* and an unlimited-liability member of a *Goshi Kaisha* are 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.

117. In general, a limited-liability member of a *Goshi Kaisha* has the right to inspect the balance sheet and review the business and the state of its 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

118. A sole proprietor (referred to in Japan as a sole trader) is an individual engaged in a business or profession for 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

119. In compliance with the requirements of the Securities and Exchange Law and related MOF ordinances, a corporation that offers its securities for sale to the public is required to file a registration statement (Form 2) with the MOF. If the total amount of the offering is less than yen 500 million but more than yen 100 million, a notification statement (Form 1) should be filed.

120. The registration statement includes information about the securities offered and an outline of the company and of business operations, the condition of its facilities, and its financial condition

(including audited comparative financial statements and supporting schedules for the last two years and information regarding the business group, including audited consolidated financial statements). The contents of the prospectus are the same in principle as those of the registration statement.

121. In case of public offering of securities by a corporation that complies with continuous disclosure requirements, a copy of the most recent MOF annual report and semiannual report filed with the MOF are used as part of the registration statement (Form 2-2). Selected large corporations subject to continuous disclosure requirements are allowed to omit the annual report and the semiannual report by inserting certain references in the registration statements (Form 2-3). In addition, there is a shelf-registration system available for corporations that comply with continuous disclosure requirements.

Requirements for Listing Securities on Major Stock Exchanges

122. A corporation that wants to list stock on certain stock exchanges must submit an Application for Listing of Securities (stock), the Securities Report for the Application for Listing (Sections I and II), and other required documents to the stock exchange. The contents of the Securities Report for the Application for Listing, Section I, is identical with Form 2 referred to in paragraphs 119 and 120.

123. The documents submitted to the exchange are examined and an application to the MOF is made for approval of listing. The prospectus for listing on the exchange is prepared with information contained in the Securities Report for the Application for Listing, Section I, and distributed to interested parties.

Continuous Disclosure Requirements for Publicly Held Corporations

124. All publicly held corporations (see paragraph 29 *b* through *d*) must file the annual report (Form 3) and semiannual report (Form 5) with the MOF within three months after the end of the annual and semiannual period. The current report (Form 9) also is required to be filed if regulated matters have occurred.

125. The annual report (Form 3) filed with the MOF contains (1) an outline of the company, (2) an outline of business, (3) an outline of business operation, (4) the condition of facilities, (5) financial

condition, (6) condition of the business group, and (7) an outline of stock administration. Financial condition includes the following:

- Financial statements (auditors' report, balance sheet, income statement, statement of appropriation of retained earnings, and supporting schedules)
- Breakdown of major accounts of assets, liabilities, and nonoperating income/expenses
- Market value information of securities, options, and futures
- Results and forecast of cash flows
- Subsequent events and other information

126. Item 6 (Condition of the Business Group) of Form 3 includes the following:

- Outline of business group
- Condition of business group (operating results of business group, audit report on the consolidated financial statements, consolidated financial statements, segment information, and condition of consolidated subsidiaries)
- Transactions between related parties

SELECTED ECONOMIC DATA

127. Key demographic and social factors, based on 1990 Japanese census data (unless otherwise indicated), follow.

Area (in millions of square kilometers)	0.38
Population (in millions)	123.6
Annual population increase	0.28%
Population under age 15	18.8%
age 15–64	69.6%
over age 64	11.6%
Labor force (in millions)	63.8
Birthrate (per population of 1,000)	10.0
Population graduated from university or community college in 1980 (millions)	12.2

128. The major Japanese trading partners for 1990 are as follows:

Country	*Exports (U.S. $ millions)*	*Imports (U.S. $ millions)*
United States	90,322	52,369
European Community	53,518	35,028
Southeast Asia	82,721	54,601
Other	60,387	92,801
	286,948	234,799

129. Japanese primary export and import products for 1990 and 1989 are as follows:

	Exports (U.S. $ millions)	
	1990	*1989*
Machinery and equipment (including motor vehicles)	215,097	205,471
Metal	19,540	21,577
Chemicals	15,872	14,776
Textiles	7,195	6,862
Nonmetalic mineral manufactures	3,226	3,053
Foodstuffs	1,646	1,687
Other	24,372	21,749
	286,948	275,175

	Imports (U.S. $ millions)	
	1990	*1989*
Energy products	56,732	43,053
Machinery and equipment	40,863	32,376
Foodstuffs	31,572	31,012
Raw materials—others	24,177	18,001
Chemicals	16,045	15,948
Metal ores and scrap	9,119	9,333
Textiles	2,643	3,337
Other	53,648	57,787
	234,799	210,847

TAXES

Principal Types

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

Corporation Income Taxes

131. Japanese corporation income taxes consist of the national corporation tax (37.5 percent of taxable income), local business tax (a basic rate of 12 percent, not to exceed 13.2 percent of taxable income), and prefectural and municipal taxes (a basic rate of 17.3 percent, not to exceed 20.7 percent of the corporation tax amount). Income tax of 20 percent is withheld at the source for interest and dividend income, and such tax is deductible from the final tax liability.

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

133. 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 the corporation's status for Japanese tax purposes.

134. Under the Japanese tax law, foreign corporations are classified as corporations operating in Japan through a permanent establishment, corporations 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.

135. 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 proper accounting records are given certain privileges, such as the carry forward of losses for five succeeding years, carryback of losses for one preceding year,

special depreciation where applicable, and the establishment of reserves.

136. A domestic family corporation, in which 50 percent or more of the total outstanding shares are held by no more than three shareholders, is liable for a special tax on earnings retained for each accounting period.

Business Occupancy Tax

137. The business occupancy tax is assessed 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 on corporate or individual owners of a building newly built or expanded for business use, in the designated city. The taxable basis is determined by the amount of space used for business and the gross payroll.

Individual Income Taxes

138. 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.

139. Income tax rates range from a low of 10 percent on annual taxable income up to yen 3 million to a maximum of 50 percent on annual taxable income over yen 20 million. The standard inhabitant tax rates range from 5 percent on annual taxable income up to yen 1.6 million, to a maximum of 15 percent on annual taxable income over yen 5.5 million.

140. In determining the tax liabilities of foreign nationals and the method of payment, it is of primary importance to determine the category into which the foreign national should be classified. Depending on the category, the scope of taxable income, the tax rates applicable, and the method of payment will vary.

141. A permanent resident is an individual who intends to reside in Japan permanently or has been domiciled or resident in Japan for more than five years. Such an individual is taxed on the basis of worldwide income.

142. A nonpermanent resident is an individual who has been resident or domiciled in Japan continuously for five years or less, and has

no intention to be resident or domiciled in Japan permanently. Such an individual is taxed on income earned or derived in Japan, and on any amounts earned or derived outside of Japan that are remitted into Japan.

143. A nonresident is an individual who has no domicile or has not been a resident in Japan continuously for one year or more. Such an individual 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.

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

Other Taxes

145. Social and labor insurance laws are applicable to all employees in Japan, and premiums are borne by employers and employees.

146. When real property is acquired, a registration tax of 5 percent of the appraised value and a real-property acquisition tax of 4 percent are assessed and payable to the tax office.

147. Goods and services supplied for use in Japan are subject to a 3 percent consumption tax. Exports are zero-rated transactions and imported products are subject to the 3 percent tax. A taxpayer with sales subject to the consumption tax of no more than yen 30 million has no tax liabilities. A taxpayer with sales subject to the consumption tax of less than yen 60 million (or yen 50 million for the taxable period beginning on October 1, 1991, and thereafter) pays a reduced tax.

148. A surtax of 20 percent on capital gains from the sale of land held for five years or less (30 percent for land held two 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 is represented by short-term land ownership. For land transactions on or after January 1, 1992, a capital gain realized from the sale of land held for two years or less

is subject to a corporate tax at 67.5 percent, which is separate from the normal corporate tax.

Tax Returns

149. Unless an extension is granted, corporate income tax returns must be filed within two months after the end of the 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.

150. A final return must be accompanied by financial statements and supporting schedules. A corporation with an accounting period exceeding six months is required to file returns covering the first six months of the accounting period and to pay taxes thereon if the taxes amount to more than yen 100,000. The returns may be provisional, reporting tax amounts calculated on a pro-rata monthly basis from the tax amounts for the preceding accounting period.

151. 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.

152. A return is also filed for business occupancy taxes. Information relative to payroll, real property, and fixed-asset taxes must be provided to appropriate government agencies.

OTHER MATTERS OF IMPORTANCE

Treasury Shares

153. 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 or other rights, and other limited cases. Acquired shares should be either canceled without delay or sold within a reasonable period.

Japanese Companies Following U.S. GAAP

154. When the preparation of consolidated financial statements became mandatory for listed and certain other companies in 1977, a

number of companies had already been publishing consolidated financial statements that were prepared in accordance with U.S. GAAP with respect to sales of securities in overseas markets prior to 1977. The MOF granted these companies the right to continue that practice. Individual financial statements of the companies making up the consolidated statements comply with Japanese GAAP.

APPENDIX A

Outstanding Auditing Pronouncements

As of May 1991, the following translated titles of laws, ministerial ordinances and pronouncements 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 Certification of Financial Statements, Etc.*
- *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*

As of May 1991, 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*

No. 14	*Auditing for Dealers of Nippon Telegraph and Telephone Corporation*
No. 15	*Standardization of Working Papers*
No. 17	*Criteria for Determination of Materiality*
No. 18	*Audit Procedures for Commercial Code Audit*
No. 25	*Use of the Work and Report of Other Auditors*
No. 26	*Standard Form of Auditor's Report on Consolidated Financial Statement*
No. 28	*Standard Form of Auditor's Report on Interim Financial Statements*
No. 30	*Standard Form of Auditor's Report on Consolidated Financial Statements for an Initial Year*
No. 37	*Audit Procedures for 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*
No. 48	*Standard Form of Letters for Underwriters*
No. 49	*Accounting for Special Money in Trust, Etc. and Auditor's Opinion*

Note: Gaps exist primarily due to statements being superseded. The Audit Committee of the JICPA issued an audit manual in 1985 that contains various samples of working papers, internal control questionnaires, audit programs, confirmation letters, audit checklists, etc. Although the audit manual is not an official professional pronouncement, it is used as a practice guide by practitioners.

APPENDIX B

Outstanding Accounting Pronouncements

As of May 1991, the following translated titles of laws, ministerial ordinances and pronouncements 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, Income Statement, Business Report and Supporting Schedules of a Kabushiki Kaisha*
- *The Ministry of Finance Ordinance Concerning Financial Statements and Related Matters*
- *The Ministry of Finance Ordinance Concerning Consolidated Financial Statements*
- *The Ministry of Finance Ordinance Concerning Interim Financial Statements*
- *The Ministry of Finance Ordinance Concerning Disclosure of Registrants' Financial Condition, Etc.*

Pronouncements of the Business Accounting Deliberation Council

- *Financial Accounting Standards for Business Enterprises*
- *Financial Accounting Standards for Consolidated Financial Statements*
- *Cost Accounting Standards*
- *Accounting Standards for Foreign Currency Transactions, Etc.*
- *Financial Accounting Standards for Interim Financial Statements*
- *Opinions Relative to Liability for Retirement Allowances*
- *Financial Reporting for Segment of a Business Enterprise*

As of May 1991, 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. 1 *Auditor's Opinions on Retirement Allowances*
No. 3 *Accounting for Depreciation*

No. 5	*Accounting for and Financial Statement Presentation of Reserve for Doubtful Receivables and Auditor's Opinion*
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. 24	*Accounting for Various Taxes and Auditor's Opinion*
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*
No. 50	*Audit Procedures for High-Risk Accounts*

Note: Gaps exist primarily due to statements being superseded.

APPENDIX C

Illustrative Auditor's Report and Financial Statements

The following financial statements are taken from the 1990 annual report of Hitachi, Ltd. and are not intended to include all information that Japanese law requires.

AUDITORS' REPORT
May 21, 1990

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

Century Audit Corporation
Y. Fukase, CPA (signed and sealed)
F. Sumita, 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 121st business year from April 1, 1989 to March 31, 1990 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, 1990
(expressed in millions of yen)

	Amount
Assets	
Current Assets	2,542,269
Quick Assets	1,868,033
Cash	934,402
Notes receivable	106,578
Accounts receivable	626,323
Marketable securities	105,954
Advances	61,593
Other quick assets	40,523
Reserve for doubtful accounts	-7,340
Inventories	674,236
Finished goods	127,468
Semi-finished goods	167,575
Raw materials	60,883
Work in process	318,310
Fixed Assets	992,227
Tangible fixed assets	525,279
Buildings	124,114
Structures	15,175
Machinery	186,349
Vehicles	456
Tools and furniture	146,131
Land	33,049
Construction in progress	20,005
Intangible fixed assets	4,036
Railway and public utility installation	1,158
Other intangible fixed assets	2,878
Investments	462,912
Stock of subsidiaries	181,991
Other securities	191,332
Long-term loans	61,069
Other investments	28,520
Total	3,534,496

(Continued on next page)

BALANCE SHEET *(cont.)*

	Amount
Liabilities and Shareholders' Equity	
(Liabilities)	
Current Liabilities	1,521,738
Notes payable	74,521
Accounts payable—trade	410,255
Short-term bank loans	209,935
Accounts payable—other	36,015
Accrued taxes	53,418
Accrued expenses	157,661
Advances from customers	369,332
Deposits from employees and others	86,062
Reserve for warranty	17,903
Reserve for exhibition at The International Garden and Greenery Exposition	2,400
Other current liabilities	104,236
Fixed Liabilities	738,921
Debentures	460,760
Long-term loans	1,157
Retirement and severance indemnities	218,479
Reserve for loss of repurchasing computers	44,316
Provision for overseas investment loss	14,209
Total Liabilities	2,260,659
(Shareholders' Equity)	
Capital Stock	246,914
Legal Reserves	250,890
Capital surplus	209,765
Earned surplus reserve	41,125
Retained Earnings	776,033
Reserve for software program development	25,253
Reserve for special depreciation	3,993
Reserve for special dividends	3,000
Earnings reserved for miscellaneous purposes	614,000
Unappropriated retained earnings at the end of the period	129,787
(Net income for the period)	(115,006)
Total Shareholders' Equity	1,273,837
Total	3,534,496

NOTES TO BALANCE SHEET

(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	yen 1,097,049 million

(4) Retirement and severance indemnities are 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) Consumption taxes are directly excluded from sales.

(6)

Short-term credit to subsidiaries	yen 388,900 million
Long-term credit to subsidiaries	yen 31,483 million
Short-term debt from subsidiaries	yen 203,846 million

(7) Other quick assets contain treasury stock of yen 49 million.

(8) The Company has leased property such as semi-conductor production equipment and computer production equipment under an operating lease (other than tangible fixed assets recorded on the balance sheet).

(9) Assets mortgaged

Investment securities	yen 1,284 million

(Continued on next page)

NOTES TO BALANCE SHEET *(cont.)*

(10)	Discount of notes receivable	yen 58,452 million
	Transfer by endorsement of notes receivable	yen 17,660 million
	Guarantees of loans	yen 75,528 million

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

(12) Net Income per Share yen 37.42

STATEMENT OF INCOME
April 1, 1989 to March 31, 1990
(expressed in millions of yen)

	Amount	
Ordinary Profit and Loss		
Operating profit and loss		
Net sales		3,525,254
Cost of sales	2,611,837	
Selling, general and administrative expenses	713,381	3,325,218
Operating profit		200,036
Non-operating profit and loss		
Other income		
Interest and dividends received	92,202	
Other	4,482	96,684
Other deductions		
Interest and discount charges	30,277	
Other	45,602	75,879
Ordinary profit		220,841
Extraordinary Profit and Loss		
Extraordinary loss		
Loss from structural improvement of business	15,935	15,935
Income before income taxes		204,906
Corporation tax and resident tax		89,900
Net income for the period		115,006
Surplus profit carried over from the previous period		29,871
Interim dividends paid		13,718
Addition to earned surplus reserve		1,372
Unappropriated retained earnings at the end of the period		129,787

NOTES TO STATEMENT OF INCOME
(expressed in yen)

Notes

(1) Loss of yen 15,935 million from structural improvement of business consists of moving expenses and loss on disposition related to this improvement.

(2) Sales to subsidiaries during the period	1,394,573 million
Purchases from subsidiaries during the period	1,532,968 million
Non-operating transactions with subsidiaries	47,161 million

Appropriation of Retained Earnings

Unappropriated retained earnings at the end of the period	129,787,077,080
Reversal of reserve for special dividends	3,000,000,000
Total	132,787,077,080
Unappropriated retained earnings disposed of:	
Earned surplus reserve	2,000,000,000
Cash dividends yen 6.50 per share (including special dividends of yen 2.00)	19,973,502,614
Bonuses payable to directors	250,000,000
Reserve for software program development	5,809,263,460
Reserve for special depreciation	2,204,706,701
Earnings reserved for miscellaneous purposes	66,000,000,000
Unappropriated retained earnings carried forward to the following period	36,549,604,305

CONSOLIDATED BALANCE SHEET
As of March 31, 1990
(expressed in millions of yen)

	Amount
Assets	
Current Assets	5,390,902
Cash	1,705,484
Marketable securities	473,034
Notes and accounts receivable—trade	1,594,265
Inventories	1,355,007
Other current assets	263,112
Long-term receivables	134,868
Investments	358,736
Tangible fixed assets	1,708,891
Other non-current assets	211,689
Total	7,805,086

Liabilities and Stockholders' Equity	Amount
Current Liabilities	3,314,907
Short-term bank loans	828,380
Notes and accounts payable—trade	928,665
Other current liabilities	1,557,862
Non-current Liabilities	1,380,753
Minority Interest	548,591
Stockholders' Equity	2,560,835
Common stock	246,913
Capital surplus	357,775
Unappropriated retained earnings	1,956,147
Total	7,805,086

CONSOLIDATED STATEMENT OF INCOME
April 1, 1989 to March 31, 1990
(expressed in millions of yen)

	Amount	
Operating profit and loss		
Net sales		7,077,855
Cost of sales	5,023,533	
Selling, general, and administrative expenses	1,553,218	6,576,751
Operating profit		501,104
Non-operating profit and loss		
Other income		
Interest and dividends received	162,317	
Others	14,760	177,077
Other deductions		
Interest and discount charges	97,047	
Others	51,144	148,191
Income before income taxes and minority interest		529,990
Income taxes		281,309
Income before minority interest		248,681
Minority interest		37,718
Net income		210,963

Note (1) Consolidated financial statements were prepared on the basis of accounting principles generally accepted in the U.S.

Note (2) The number of consolidated subsidiaries is 712 for the subject year.

APPENDIX D

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

General Information	Answer	Comments
1. Is a primary purpose of an audit—		
a. To attest to information used by investors, creditors, etc.?	Yes	
b. To satisfy statutory requirements (for example, the Companies Act)?	Yes	1*b.* The Commercial Code and the Securities Transactions Law.
c. For tax purposes?	No	

Notes:

Checklist was 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.
This checklist does not include the latest GAAS pronouncements issued in the United States.

General Information	Answer	Comments
2. A. The United States has ten generally accepted auditing standards including general standards, standards of fieldwork, 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 Japan?	Yes	2A–C. They are composed of eleven Auditing Standards ("AS"), 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, Special Measures Law Concerning Audit, etc. of a *Kabushiki Kaisha*, the Regulations Concerning Audit Report of a Large-scale Corporation (the Ministry of Justice), and the MOF Ordinance of Audit Certification of Financial Statements, etc. ("MOA") also govern auditing.
B. If so, are they published?	Yes	
C. If auditing standards exist in Japan, are they similar to U.S. standards?	Yes	
D. If not, what are they?		
3. Who is responsible for promulgating auditing standards (for example, the profession, a governmental body, etc.)?	See Comment for question 2A	

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncements	Predominant Practice	Minority Practice	Not Done	Comments
4. Do auditors confirm receivables? (AU 331)	Yes. WRFW II-1(3)-2, 3 and ACP 7 and 50	✓			
5. Do auditors observe inventory counts? (AU 331)	Yes. WRFW II-1(3)-6, ACP 8	✓			

6. Do auditors receive written representations from management? (AU 333)	No		✓	
7. Do auditors receive written representations from management's legal counsel? (AU 337)	No		✓	7. WRFW II–1(3)–19 requires confirmation relative to subsequent events.
8. A. Do auditors prepare and maintain working papers? (AU 339)	Yes. WRFW I–7	✓		
B. If so, do they include a written audit program outlining procedures to be performed? (AU 339)	No	✓		8B. There is no explicit requirement.
9. Do auditors obtain a sufficient understanding of the internal control structure to plan the audit and to determine the nature, timing, and extent of tests to be performed? (AU 319)	Yes. AS II–1 WRFW I–3 II–1(1)–1, 2	✓		
10. A. Do auditors communicate reportable conditions in the internal control structure to the audit committee? (AU 325)	No		✓	
B. If so, is the communication documented? (AU 325)				
11. In obtaining evidential matter, does the auditor apply either statistical or nonstatistical procedures? (AU 350)	Yes. AS II–2 WRFW I–3	✓		11. Both AS and WRFW indicate that the work should be done on a test basis.
12. Is the auditor responsible for designing the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements? (AU 316)	Yes. AS II–3	✓		12. The standard requires taking into consideration materiality, relative risk, and other elements inherent in the items.

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncements	Predominant Practice	Minority Practice	Not Done	Comments
13. A. Does the auditor perform procedures to identify related-party transactions and their effects on the financial statements? (AU 334)	Yes. WRFW II–1(2)–11, (3)–20	✓			
B. If so, list the procedures.					13B. The auditor should— • Make inquiries to identify the related parties. • 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, etc. 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 recorded.
14. Does the auditor consider the adequacy of cut-off procedures to ensure that movements into and out of inventories are properly identified in the accounting records? (AU 313)	No	✓			

15. A. Are specific auditing procedures applied to transactions occurring after the balance-sheet date? (AU 560)	Yes. WRFW II–1(3)–19	✓		
B. Are other auditing procedures applied to ascertain the occurrence of subsequent events that require adjustment to or disclosure in the financial statements? (AU 560)	Yes. WRFW II–1(3)–19 and the related guideline	✓		
16. The concept of "joint auditors" in certain countries (e.g., 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 United States. 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 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. 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 no reference should be made to other auditors in the opinion paragraph of an audit report.

U.S. Generally Accepted Auditing Standards	Required by Government or Professional Pronouncements	Predominant Practice	Minority Practice	Not Done	Comments
18. A. Is there a standard form of auditor's report? (AU 508)	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—ACP 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 508)	MOA 4, WRR III and IV ACPs 2 and 41				18B. See paragraph 48 of text.
19. A. Does the auditor's report require an explanatory paragraph for a change in accounting principles or in the method of their application? (AU 508)	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 that 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 530)	No. WRR I			✓	
B. If not, what date is used?	See Comment				20B. Date of preparation.
21. To express an opinion, must the auditor be independent? For the purpose of this checklist, independence is defined as not having a financial interest in or connection	Yes. CPA Law 24, 34–11 AS I-1	✓			21. A certain level of financial interest is permitted. See paragraph 8 of text.

with the client. (Code of Professional Conduct, Rule 101 and its interpretations)

22. Please describe any standards in Japan for which there are no corresponding U.S. standards.

22. There are no U.S. standards corresponding to the following Japanese standards: *Auditing Standards for Interim Financial Statements* (Statements issued by the Audit Committee and other bodies of the Japanese Institute of Certified Public Accountants)

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 With 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, etc.)?		2. The following are responsible for promulgating accounting principles: • The Commercial Code (CC) and related Commercial Code Ordinances (CCO) • Ministry of Finance (MOF) rules relative to parent-only financial statements (PR), consolidated financial statements (CR), and interim financial statements (applicable to the parent only) • Ministry of Finance Ordinance regulations concerning disclosure of registrants' financial condition, etc., for preparation of the registration statement, annual report, and other periodic reports

- Business Accounting Deliberation Council accounting standards (AS), cost accounting standards (CAS), accounting standards regarding foreign currency transactions (ASFC), disclosure requirement for segment information (DRSI), other standards, and various opinions
- Audit Committee of the Japanese Institute of Certified Public Accountants (JICPA) pronouncements on acceptable accounting practices by auditors (ACP) and periodic pronouncements issued by other bodies of the JICPA

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncements	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)	No. CC34, 285–2			✓	
B. If so, define the basis.					

Notes:

References are to sections in the *FASB Current Text*, unless otherwise noted.
This checklist does not include the latest GAAP pronouncements issued in the United States.

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncements	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 determined 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. 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.
9. A. Are consolidated financial statements required when one company has control over another company? (C51)	Yes. CR5	✓			9A. See paragraphs 65 and 66 of text.
B. Is control usually indicated by ownership of over 50 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. When consolidation of a subsidiary would be misleading.

					However, the fact that the nature of a subsidiary's business 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. For parent-company-only financial statements, the investment should be at cost or less.
12. Are there two methods of accounting for business combinations—the pooling-of-interests method and the purchase method? (B50)	No	✓			12. There are diverse accounting practices for business combinations in Japan.
13. Is the method used to account for a business combination disclosed? (B50)	No			✓	13. There is no specific requirement.
14. A. Do criteria exist for treatment of business combinations as a pooling of interests? (B50)	No			✓	14A. Since mergers and consolidations occur infrequently in Japan, there is no authoritative literature on this subject.
B. If so, list the criteria.					
15. A. Is goodwill arising from a business combination accounted for as an asset? (I60)	See Comment		✓		15A,B. Goodwill may either be capitalized or charged to operations. If capitalized, it should be amortized within five years (CC 285-7).
B. If so, is it amortized as a charge to income over the period estimated to be benefited?	No. CC285–7			✓	
16. Are the following disclosures made for related-party transactions: (R36)					
a. The nature of the relationship?	Yes	✓			

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncements	Predominant Practice	Minority Practice	Not Done	Comments
b. A description of the transactions for the periods presented?	Yes	✓			
c. The amounts of the transactions for the periods presented?	Yes	✓			
d. The amounts due to or from related parties at the balance-sheet date?	Yes	✓			
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	✓			17. A loss is accrued if it is highly anticipated rather than 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 United States, 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 a public enterprise's financial statements for each industry segment: (S20)				
a. Sales to outsiders and inter-segment sales?	Yes. DRSI	✓		20*a,b.* An annual report submitted to the MOF is required to include this segment information (MOF Ordinance).
b. Operating profit or loss?	Yes. DRSI	✓		
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?	No		✓	
21. A. Are there any requirements or recommendations to disclose the effects of inflation? (C28)	No		✓	
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)	Yes. CCO7 and 8	✓		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 Pronouncements	Predominant Practice	Minority Practice	Not Done	Comments
B. If so, what is the basis (e.g., percentage of sales, aging of receivables, etc.) for calculating the allowance?					24B. Percentage of sales or receivables and identification of specific receivables, among others, are used as the basis of the computation. Many companies use the allowable limit for tax purposes, which is computed based on net receivables.
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 significantly lower than the cost and is not expected to recover, such inventory should be marked down to market and charged to nonoperating expense or extraordinary loss. If the lower of cost or market is adopted, devaluation of inventory to market should be charged to cost of sales or nonoperating loss. (AS note 10)
C. Is the basis disclosed?	Yes. CCO3	✓			

27. Does cost for inventory purposes include: (I78)				
a. Materials?	Yes. CAS32	✓		
b. Direct labor?	Yes. CAS32	✓		
c. Factory overhead?	Yes. CAS33	✓		
d. If the answer to *c* is yes, is an allocable share of all factory overhead included?	Yes. CAS10 and 30	✓		
28. A. Are the following cost methods permitted for reporting purposes: (I78)				28A. The specific identified cost method and retail method are also acceptable.
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.
B. If so, is an accumulated depreciation account used?	Yes. CCO15	✓		
31. Are disclosures made of—(D40)				
a. Depreciation expense for the period?	Yes	✓		31*a.* 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	✓		

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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. See paragraph 82 of text.
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		✓		33A. See paragraph 82 of text.
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	✓			
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			✓	35A,B. Liabilities incurred through trade transactions are treated as current, and nontrade 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—(C32)					
a. Interest rates?	Yes	✓			36*a,b*. Public companies are required to disclose in a long-

				term debt schedule in a MOF report, maturities and those debt instruments bearing unusual or no interest.
b. Maturities?	Yes	✓		
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? (Co4)	Yes. AS note 7	✓		
B. If so, what are the criteria for determining the method to be used?				37B. Since both methods are acceptable, the choice is left to management's discretion.
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 United States, 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	No. CCO42		✓	

U.S. Generally Accepted Accounting Principles	Required by Government or Professional Pronouncements	Predominant Practice	Minority Practice	Not Done	Comments
reasonably be expected to recur in the foreseeable future. Do similar criteria for identifying extraordinary items exist in Japan? (I17)					
B. If not, what are the criteria?					40B. Extraordinary items include (1) prior-period adjustments, which consist of (*a*) adjustments of accumulated depreciation due to a change in useful lives or depreciation methods on a retroactive basis, (*b*) adjustment of prior provisions, (*c*) other adjustments related to revenue or expenses recorded in prior periods; (2) profit or loss on sale of fixed assets, including intangible assets and investments; (3) other extraordinary profit or loss.
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	✓			
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		42B. Extraordinary items should be presented after ordinary profit or loss. Disposal of a segment of business is not specifically required to be disclosed.
43. A. Are pension costs provided for covered employees over the term of employment? (P16)	Yes. AS opinion 2, and ACP 33 and 35	✓	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 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 (40 percent is the allowable limit for tax purposes, and 50 percent was the allowable limit before 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 in 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 on a systematic basis over five years.

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44. A. Are specific disclosures required relating to pension plans? (P16)	No			✓	
B. If so, list them.					
45. A. When accounting income and taxable income differ, are deferred income taxes recorded for temporary differences (as opposed to permanent differences)? (I25)	No		✓		45A. Deferred tax accounting may be adopted only when consolidated financial statements are prepared. See paragraph 86 of text.
B. If so, are deferred taxes provided for all timing differences (as opposed to only those meeting certain criteria)?	See Comment				45B. Deferred taxes may be provided for either on a partial basis or for all items that give rise to a timing difference.
46. A. Are deferred taxes determined on the basis of current tax rates? (I25)	See Comment				46A,B. Since there is no authoritative literature on this subject, either the deferral 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? (I25)	No			✓	
B. If so, list the requirements.					
48. A. Are operating losses reported on the income tax return allowed to be carried back to earlier periods? (I25)	No			✓	
B. If so, are the tax effects of a loss carryback included in the income in the period?					

49. A. Are operating losses reported on the income tax return allowed to be carried forward? (I25)	Yes. Corporation Tax Law 57	✓		49A. Permitted for 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 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 93 of text.
52. A. Are translation adjustments reported separately? (F60)	Yes. CR40	✓		52A,B. See paragraph 93 of 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)	✓		

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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 transactions? (F60)	Yes	✓			
55. What information is disclosed about foreign currency restrictions? (F60)	See Comment			✓	55. No information is required to be disclosed.
56. Are significant events arising subsequent to the balance-sheet date reflected in the financial statements or notes thereto? (C59)	Yes. CCO45, PR8–4	✓			
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 JICPA for which there are no corresponding U.S. standards: 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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