Origins of the Corporate Audit Function in Japan: A Review and Comparison

Yoshinao Matsumoto*

Gary John Previts**

Corporate audits in Japan have at least two objectives: 1) stewardship: ensuring management is running the company well, which is important to current stockholders in overseeing management to include deciding how to compensate managers and how to distribute earnings to shareholders, and 2) disclosure: providing useful information for the public capital markets, to include potential investors.

In our paper, we consider statutory influences upon the audit as found in Japan and the United States. We consider the differences between public company auditing in the U.S. and the statutory audit and securities law audits oriented in Japan. We provide an example comparing a public company audit report based on recent U.S. standards and an audit report based on Japanese standards. We find that Japanese audits have evolved so as to provide both for both stewardship and disclosure objectives and thus differentiate between the needs of stockholders and potential public investors whereas U.S. audits, with a public capital market disclosure orientation, do not make a distinction, i.e. there is a propensity to rely upon disclosure as the principal objective for public company auditing.

This difference appears to have been influenced in part by the legal requirements in each country (the Commercial Code in Japan and Securities Legislation in the U.S.) and the history of economic sourcing of capital [banking vs. equity markets, for example] peculiar to each nation. The passage of Securities Law in Japan, which followed the end of World War II, suggests that the period of U.S. occupation was an influence which have may have affected the traditional stewardship audit function in Japan, supplementing it to meet the disclosure objective as public capital markets were fostered in the Japanese economy.

Keywords: audit function, mandatory audit, statutory disclosure, accountability, conflict of interests, information usefulness, Commercial Code [Japan], Securities Act [United States].

* Professor, School of Accountancy, Kansai University

** Professor, Department of Accountancy, Weatherhead School of Management, Case Western Reserve University

I. Introduction

Since the Sarbanes-Oxley Act was passed on July 30, 2002 in the U.S., the Japanese economic community, accounting profession, and regulators have been assessing its potential effect on Japan. This Act requires the U.S. Securities and Exchange Commission (SEC) to ensure that foreign enterprises that are listed on U.S. securities markets adopt a corporate governance model similar to the U.S. model. In addition, the Act requires foreign audit firms to register with the Public Company Accounting Oversight Board (PCAOB) and to comply with U.S. auditing standards.

The Japanese economic community and Japanese government regulators (the Financial Services Agency: FSA) opposed this extraterritorial application of U.S. laws by the SEC and complained that it ignored the traditional style of corporate governance that arose from Japan's social, economic, and legal background. They called instead for a mutual authorization of each country's unique auditing system. The basis for the concerns expressed in Japan and the role of such extracultural influences can perhaps be best understood by examining the objectives of auditing and the traditional influences in each of these settings.

U.S. corporate governance consists of a board of directors that includes a compensation committee, nomination committee, and audit committee. In order to protect stockholders' interests, each of these committees is expected to consist of outside directors. In Japan, to serve the same purpose, the board of directors and a board of corporate auditors are established separately.

In Japan, audits have two evolved to support two separate objectives which address the needs of two different kinds of users: The first function, stewardship, ensures that management is running the company well and seeks to decide the amount of dividends to pay shareholders versus how much to pay top managers. This function is important to current stockholders in their role of overseeing management. The second function, disclosure, provides useful information for the public securities markets including individual shareholders and potential shareholders (AAA [1973]). This function supports the notion of a public capital market and individual ownership in corporate equity shares.

In this paper, we compare how these objectives are addressed in the audit processes and reports used in Japan and in the United States.

II. Dual Mandatory Corporate Disclosures

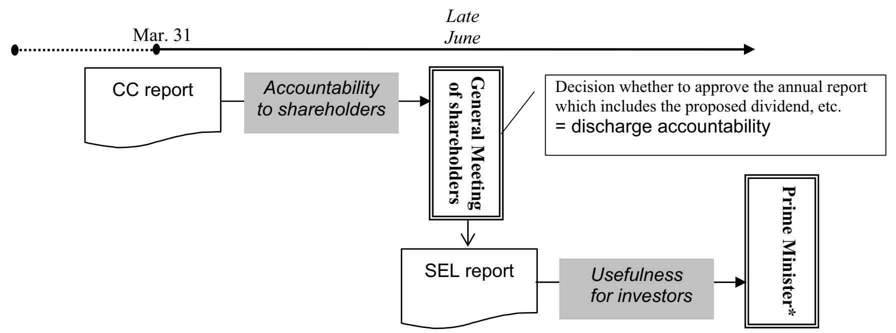
Audits of Japanese companies in modern times (the last century) is based on two laws that reflect French and U.S. influence. Two laws, which have different purposes, require companies to provide disclosures to interested parties: 1) the Commercial Code (CC) which was enacted in 1890 and was based mainly on the French Commercial Code (Company

Act)[1] and 2) the Securities and Exchange Law (SEL) enacted in 1948 (requiring audits to begin in 1951) which was based on U.S. Securities and Exchange Law.

The Commercial Code is supervised by the Ministry of Law and requires a stock company to prepare an annual report and supplementary schedules for submission to the general shareholders meeting. The annual report includes, in addition to various business reports, a balance sheet, a statement of income with a statement of unappropriated retained earnings, and a statement of *proposed appropriations* for the unappropriated retained earnings. This latter statement represents management's proposed compensation for the directors as well as the amount of dividends to be paid to stockholders.

The Securities and Exchange Law requires registrants to file annual and semi-annual reports with the Financial Services Agency (under the direction of the Ministry of Finance) and send copies to the stock exchanges where securities are listed. The SEL annual report includes nearly identical statements to those found in the CC annual report except for the statement of proposed appropriations of *unappropriated* retained earnings, which is omitted. Because the SEL annual report is prepared after the CC annual report has been approved by a general meeting of stockholders, the SEL report includes a statement of *appropriated* retained earnings (See Figure 1).

Figure 1 Temporal Relationship of CC and SEL Audit Reports



- N.B., Since 2000, many securities market/financial services matters, including the disclosure of the SEL report, are overseen by the Financial Services Agency along with the Securities and Exchange Surveillance Commission SESC. Planning of financial policy however remains with the Ministry of Finance (MOF). The SESC was established in July 1992 following 1991 market scandals in Japan.

As shown above, while both of the laws require preparation of annual reports, the party that receives each annual report is different and the purposes for preparing the reports are

1) Cf., Tsuchiya [1956].

also different. The CC annual report — prepared in advance of the stockholders general meeting — provides stockholders with the information necessary for them to approve the statement of accounts prepared by management and to discharge management's accountability. The SEL report functions to protect the liquidity in the capital market by supplying information to investors.

III. Dual Mandatory Audits

When the CC was enacted in 1890, the CC corporate auditor's role was specified and required of every stock company. The scope of the audit depends on the company's size (See Table 1).

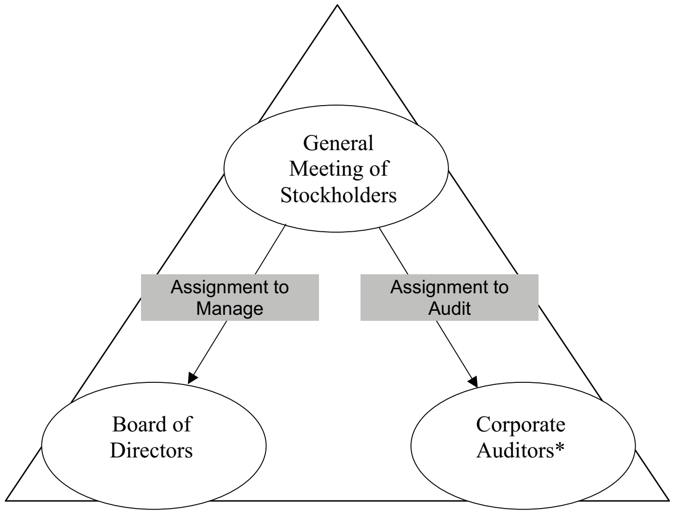
Table 1 Contents of the Audit Prepared by the CC Corporate Auditor by Company's Size

Contents / Size	Accounting Audit	"Operational Audit"
Outstanding Common Stock >500million or Total Liabilities >20,000million "Large Company"	Yes	Yes
Outstanding Common Stock >100million and <500million "Medium Company"	Yes	Yes
Outstanding Common Stock <100million or Total Liabilities <20,000million "Small Company"	Yes	No

This audit examines the director's business operation including facility investment, sales strategy, accounting policy, etc. The CC corporate auditor is as an agent entrusted to audit the operations, reports and actions of the board of directors and management, who are entrusted to manage for the stockholders from a stockholder's point of view (See Figure 2). Both the directors and the CC corporate auditor are elected by the general meeting of stockholders. This structure bears some similarity to the U.K. stock company under the Company Act[2].

2) In the U.K., the 1947 Company Act requires members of the organized accounting profession to serve auditors.

Figure 2 The Order of Authorities in a Japanese Joint-Stock Company under the CC



* Beginning in 1993, Large Companies must have a Board of Corporate Auditors that is composed of at least three members and, since 2002, must include a majority of members from outside of the company.[3)]

III-1. Purpose of Dual Mandatory Audits

The CC corporate auditor is required to monitor the directors' activities and to examine an annual report of accounts. Also, the CC corporate auditor expresses an opinion at the general meeting of stockholders about whether shareholders should approve the annual report. This opinion is not an expression about the overall fairness of the annual report but serves to provide information about the stewardship of management and therefore the *legitimacy* of the management's annual report as a statement about the discharge of their obligations.Specifically this "legitimacy opinion" is expressed when accounts comply with particulars of the articles of incorporation. If the CC corporate auditors identify a violation, even a minor or a single exception, they will include a "non-legitimacy" opinion in their report. The legitimacy statement is meant to draw the attention of readers of financial statements (the shareholders) to CC-related management violations in the annual report so they can decide whether to approve the report on accounts prepared by management. This "legitimacy" opinion differs from the type of overall fairness opinion that the SEL auditor

3) The revision of the CC in 2002 allows CC Large Companies to adopt U.S. style corporate governance, which consists of a board of directors including an audit committee, nomination committee, and compensation committee.

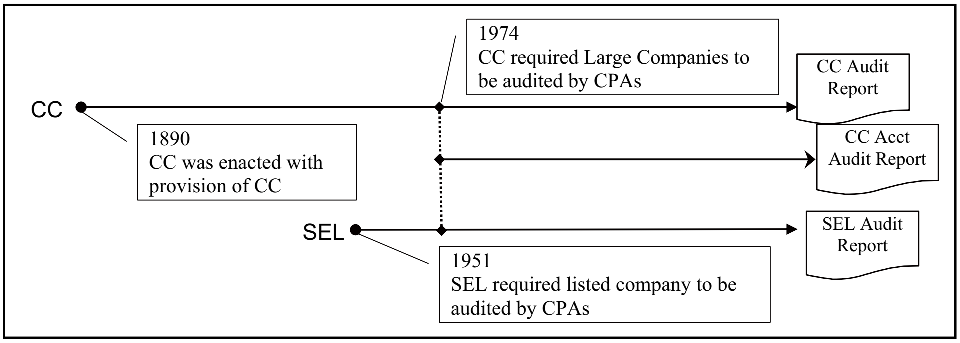
provides to investors about the degree of reliability of the financial statement. The CC audit is limited to assisting the stockholders in deciding whether to approve the company accounts at the general meeting. Even if the CC corporate auditor's report expresses legitimacy concerns in the opinion, the accounts still could be accepted if the general meeting of stockholders elects to do so.

On the other hand, the Japanese SEL audit, which came into effect in 1951, is similar to other countries' audits under so-called "Securities Laws." The SEL auditor is selected from among CPAs and the SEL audit is mandated for the following companies:

(1) Companies initially listing and already listed on stock exchanges
(2) Companies initially registering and already registered with the Japan Securities Dealers Association
(3) Companies that are initiating an initial offering or have offered to *the public securities of at least ¥500 million*
(4) Companies with *at least 500 shareholders*

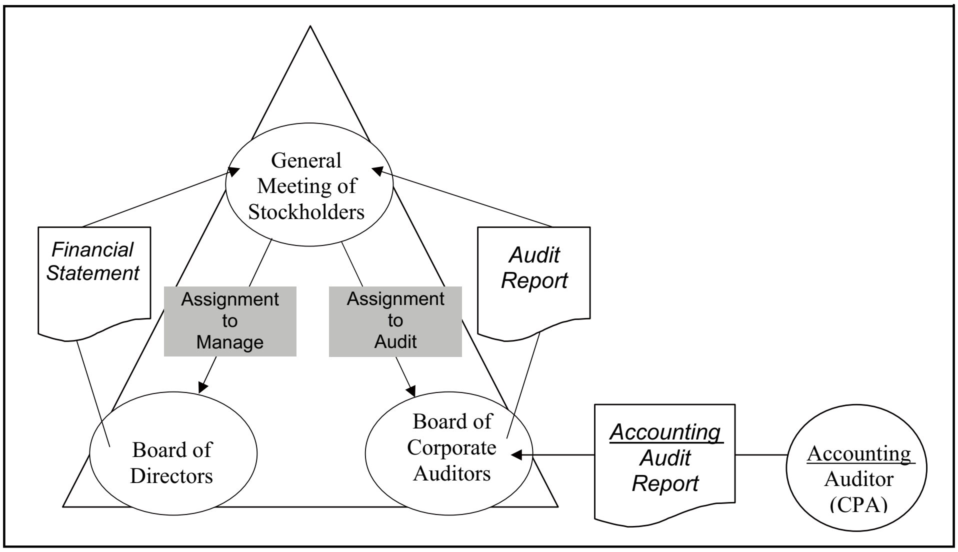
Companies that meet requirement (3) must have an SEL audit and also are included in the CC Large Company category. These "large" companies are audited by different auditors under the CC and SEL. However, following a series of significant fraud cases in the 1960s, legislators revised the CC and introduced a requirement that accounting professionals (CPAs) also provide the CC audit for Large companies, beginning in 1974 (See Figure 3).

Figure 3 Historical Timetable of CC sharing CPA as an Accounting Auditor with SEL



Along with requiring CPAs to conduct the CC audit, the CC corporate auditor now also has the right to judge the acceptability of the accounting auditor's report. This relationship is depicted in Figure 4.

Figure 4 Relationship between the Reports of the CC Corporate Auditor and the CC Accounting Auditor since 1974



III-2. The Relationship between the CC Corporate Auditor and the CC Accounting Auditor

The methods and reports of the CC corporate auditor and the CC accounting auditor differ due to their different purposes and premises. The CC audit opinion is necessary to fulfill the directors' responsibility to provide information to the general meeting of stockholders, which approves the accounts prepared and submitted by the company's directors. Once accepted by the shareholders, the SEL audit accepts as a given the approval of accounts and concentrates on ensuring that the data in the financial statements are useful for making investment decisions.

As shown in Figure 4, the CC corporate auditor has the authority to provide not only an accounting audit but also an operational audit of management. Between the two audits, the CC accounting audit is more important for stockholders and requires careful attention, particularly in the "large" company, for which a CPA auditor is commissioned to do the accounting audit for use by a CC corporate auditor. In the end, the CC corporate auditor decides whether the accounting auditor's report is acceptable.

The number of companies for which a CPA is the CC accounting auditor is shown in Table 2.

Table 2 Number of SEL and CC Audited Companies in which the Audits are Performed by CPAs*

SEL Audited Companies issuing Individual F/S		SEL Audited Companies issuing Consolidated F/S	
No. of Companies	1,076	No. of Companies	3,087
Total			4,163

(as an Accounting Auditor)

CC Audited Companies based on Capital		CC Audited Companies based on Liability	
No. of Companies	5,641	No. of Companies	1,043
Total			6,684

* Apr. 1, 1999 to Mar. 31, 2000

There is no official data about companies audited by CC corporate auditors under the CC only.

(JICPA [2001] pp. 6-8.)

When the CC accounting auditor's report is accepted by the CC corporate auditor, this report is included in the CC corporate auditor's report and is submitted to the general meeting of stockholders. To show the contrast between the contents of the reports prepared by the CC accounting auditor and the CC corporate auditor, Figures 5-1 and 5-2 show actual auditors' reports included in published annual reports.

Figure 5-1 Auditors' Reports for Stockholders in Japan —Toyota

Accounting Auditor's Report for Toyota*

Audit report

May 10, 2001

TOYOTA Motor Corporation
President, Director: Mr. Fujio Cho

Aoyama, Chuo audit corporation
Representative and
Participant partner, CPA: Tajima
Representative and
Participant partner, CPA: Horie
Representative and
Participant partner, CPA: Yamamoto

This audit corporation was commissioned based n a provision of the "Act regarding Special Rules of the Commercial Code for Large Company Audits." We audited Toyota's Balance Sheet, Income Statement, Business Report (limited to the portion about accounting), Surplus Appropriation Plan, and Affiliated Detailed Statement (limited to the portion about accounting) of the 97th business year from April 1, 2000 to March 31, 2001. Regarding the Business Report and Affiliated Detailed Statement: the accounting portion that was audited is a description based on the record of the accounting books concerning matters stated in the Business Report and Affiliation Detailed Statement.

In this audit, this audit corporation, in accordance with generally accepted auditing standards, executed audit procedures that we considered necessary.
These audit procedures contained an audit procedure of subsidiaries that we considered necessary.

As a result of the audit, our opinion is as follows:

(1) *We find that the Balance Sheet and Income Statement correctly present the company's circumstances regarding property and profit and loss according to decree and article.*
(2) *We find that the Business report (limited to the portion about accounting) correctly presents the circumstances of the company according to decree and article.*
(3) *We find that the Surplus Appropriation Plan conforms to decree and article.*
(4) Regarding the Affiliated Detailed Statement, there is no matter which must be pointed out in accordance with the provisions of the Commercial Code.

Subsequent events stated in the Business Report may cause material effects to the conditions of property or profit and loss in the next period.

Between this company and this audit corporation or participation partner, there is no beneficial interest that must be stated in accordance with provision of the Certified Public Accountant Law.

Board of Corporate Auditors' Report for Toyota*

Audit report

On exercise of the functions of the director in the 97th business year from April 1, 2000 to March 31, 2001, this Audit Committee received reports of the audit and consequence from each auditor, discussed them, prepared this audit report, and reported as follows:

1. The scope of the auditor's audit

Each auditor attended meetings of the board of directors and other important meetings in accordance with audit policy and the audit execution program fixed at the audit committee. Each auditor collected reports of business operations from the directors and employees, inspected important approval documents, investigated the affairs and condition of property in the headquarters, factories, and places of work, and requested its subsidiaries to report business operations as needed.

And *we received a report and clarification from the accounting auditor, and examined the financial statement and affiliated detailed statement.*

In addition to the audit procedure described in the statement above, we investigated the circumstances of transactions, which included business conflict transactions by the directors, conflict of interests transactions between the directors and the company, the company's supply of profit with free of charge, transactions with subsidiaries or stockholders that are out of the ordinary, and acquisition and disposal of treasury stock, in detail as needed.

2. As a result of the audit

(1) *We find that the procedures and conse¬quences of the audit by the Aoyama, Chuo audit corporation, which is an accounting auditor, are acceptable.*
(2) *We find that the Business Report correctly presents the circumstance of the company in accordance with decree and article.*
(3) *We find that the Surplus Appropriation Plan is acceptable in stating the circumstances of the company's condition of property, etc.*
(4) Because an Affiliated Detailed Statement presents matters that should be stated exactly, we do not find matters that should be pointed out.
(5) *About accomplishments of charges of director that includes duties for subsidiaries, we do not find material facts violating decree and article or inadequate acts.*

About the transactions which include business conflict transactions by the directors, conflict of interests transactions between the director and the company, the company's supply of profit with free of charge, transactions that are out of the ordinary with subsidiaries or stockholders, and acquisition and disposal of treasury stock, we do not find any breach of duty of the directors.

	May 15, 2001 TOYOTA Motor Corporation Board of Corporate Auditors Full-time Auditor: Inoue Full-time Auditor: Miyahara Auditor: Toyoda Auditor: Okamura Auditor: Ioku Note: Auditors; Toyoda and Okamura are outside auditors in compliance with the provisions of “Act Article 18 Sub-Section 1”.

* These auditors’ reports were sent to the stockholders along with the notice informing stockholders of the upcoming annual stockholders meeting.

The differences in the opinion sections between the CC accounting auditor’s report and the CC corporate auditor’s report are the following:

- Generally, both of these auditors’ reports indicate only the legitimacy of the accounts and the director’s operation. Unlike the SEL auditor’s opinion, they do not designate the degree of credibility of the accounts and operations. The CC corporate auditors are not expected to reveal the degree of credibility in the report. Instead, stockholders have the right to discuss and consider the directors’ operation and accounts while referring to the auditors’ reports. They also give the auditors an opportunity to explain the details of their opinion about legitimacy judgment at the meeting (see Table 3). This statement appeared in a section of the auditors’ opinion.
- Since the CC corporate auditor has primary authority from the stockholders to examine the directors’ operation including the accounts, the CC accounting auditor submits his report to the CC corporate auditor. The CC corporate auditor then judges the acceptability of the audits and results.
- Note that the CC corporate auditor can order the directors to suspend any action which conflicts with the company’s interests (see Table 3).

(Toyota [2001a])

Figure 5-2 Auditors’ Reports for Investors — Japanese vs. U.S. Reports

SEL Auditor’s Report for Toyota	1934 Act Auditor’s Report for GM (same as for stockholders)
<u>Audit Report</u> June 27, 2001 TOYOTA Motor Corporation President, Director: Mr. Fujio Cho Aoyama, Chuo audit corporation Representative and Participant partner, CPA: Tajima Representative and Participant partner, CPA: Horie Representative and Participant partner, CPA: Yamamoto	<u>Independent Auditors’ Report</u> General Motors Corporation, its Directors, and Stockholders: We have audited the Consolidated Balance Sheets of General Motors Corporation and subsidiaries as of December 31, 2000 and 1999, and the related Consolidated Statements of Income, Cash Flows, and Stockholders’ Equity for each of the three years in the period ended December 31, 2000. Our audits also included the financial statement schedule listed at Item 14. These financial statements and the financial statement schedule are the responsibility of the Corporation’s management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

This audit corporation audited Toyota Motor Corporation's financial statement of the 97th accounting period from April 1, 2000 to March 31, 2001, which contains a balance sheet, income statement, statement of appropriation of profit and affiliated detailed table, in order to prepare an audit certificate according to Securities & Exchange Law Article 193-2. This audit was based on generally accepted auditing standards and included audit procedures that we considered necessary. As a result of the audit, we find that accounting principles and procedures adopted by this company are in accordance with generally accepted accounting principles, continue to be applied according to principle, are the same as in the previous business year, and that the representation procedure of the financial statement is correctly based on the rules of preparation (Rule 59th of Ministry of Finance [1963]). Accordingly *we find that the above-mentioned financial statement presents fairly Toyota's financial position as of March 31, 2001 and the results of operations for the year ended March 31, 2001.* Between this company and this audit corporation or participant partner, there is no beneficial interest that must be stated in accordance with the provisions of Certified Public Accountant Law.	We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, *such financial statements present fairly, in all material respects, the financial position of General Motors Corporation and subsidiaries at December 31, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America.* Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole presents fairly, in all material respects, the information set forth therein. Deloitte & Touche LLP Detroit, Michigan January 17, 2001

(Toyota [2001b]; GM [2000a] [2000b])

The Japanese SEL audit opinion consists of three discrete statements that are aggregated into a single opinion letter about the fairness of the financial statements.[4] The SEL audit opinion differs from the opinion of the CC audit since the SEL financial statement is disseminated broadly to all investors while the CC account document is used specifically for deliberation at the shareholders general meeting.

IV. Dual Functions of CC and SEL Audits

Each auditor's function is different because the purpose and premise of each mandatory audit are different. The CC corporate auditor expresses an opinion for decisions at the stockholders' meeting, while the SEL auditor supplies an audit report for public investors through the Financial Services Agency. Investors consist of many kinds of interested parties

4) Since the Japanese auditing standards were revised in 2002, the opinion paragraph in an SEL audit report for the accounting year ended March 31, 2003 will be changed and will integrate these three discrete statements into the GAAP compliance statement along with the overall fairness opinion. The form of the opinion paragraph will be almost identical to the U.S. form.

— not only stockholders and creditors, but employees, labor unions, and customers — even though shareholders, who the CC intends to protect from management malpractice, are the only current stock/equity holders.

IV-1. Auditor's Independence Reflects these Dual Functions

Since the CC audit report is prepared only for use at the general meeting of stockholders, the CC corporate auditor's contribution is directed only to the stockholders and not other interested parties. The CC corporate auditor is independent from management and the directors in order to assure integrity to stockholders' interests. In other words, the CC corporate auditor has allegiance to stockholders.

On the other hand, the SEL audit report may be disseminated broadly all over the world. It is a general purpose report. Not only is the report used by investors deciding whether to invest, but also by banks deciding whether toprovide the company a loan or by the union as it negotiates with management on a labor contract. Clearly, the interests of employees could conflict with stockholders as well as with management. Under such circumstances, the SEL auditor is required to be independent from all interested parties, not just management. Further, the SEL auditor must have an objective attitude that includes apparent and subjective independence or as is said in the U.S., independence in appearance and in fact.

Table 3 shows the responsibilities of each auditor in the system of Japanese corporate governance including mandatory audits and voluntary internal audits, in order to assist in identifying the difference in each audit function. Further, the SEL audit addresses management fraud.

Table 3 Each Auditor's Responsibilities in Corporate Governance

		CPA or Audit Corporation		
	CC Corporate Auditor (Commercial Code)	CC Accounting Auditor [CC Special Rule for Large Companies]	SEL Auditor <Securities & Exchange Law>	Internal Auditor
Qualification	*none*	CPA or audit corporation [4]	CPA or audit corporation <193-2>	*none*
Scope of audit	• director's operation (274) • accounting (CC-F/S) (281)	accounting (CC-F/S) [13]	accounting (SEL-F/S) <193-2>	*Other division's operation*
Appointment	General meeting of stockholders (183) (nominated by director)	General meeting of stockholders [3] (nominated by director with agreement of board of corporate auditors)	----------*	*Management*
Term	4 years (273)	1 year [5-2] (automatically reappointed)	----------*	*by-law*
Presentation to general meeting of stockholders	Yes (237-3; 275)	Yes [17]	----------*	*none*
Attendance at meetings of board of directors	Yes (260-3)	*none*	*none*	*none*
Investigation of Subsidiaries	Yes (274-3)	Yes [7]	----------*	*by-law*
Order of suspension to directors	Yes (275-2)	*none*	*none*	*none*
Presentation to board of corporate auditors	----------	Yes [8]	----------*	*by-law*
Representation of company	Yes (275-4) IF director v. company	none	*none*	*none*
Submit audit report to	Board of directors (281-3) [14]	Board of corporate auditors & Board of directors [13]	*President*	*Management*
Opinion	• Acceptability of accounting auditor's report • Legitimacy of directors' operation (281-3) [14]	Accuracy of each account in CC F/S (≠ fairness) (281-3) [13]	Fairness of SEL F/S <193-2> *GAAS*	*Effectiveness & efficiency (by-law)*
Compensation	General meeting of stockholders (article) (279)	*contract*	----------*	*by-law*

* In almost cases, the CC accounting auditor and the SEL auditor are the same audit corporation.
• Italic font indicates no mandatory rule.
• (xxx-x) is the Commercial Code article.
• [xx-x] is the Special Rule for CC Large Companies article.
• <xxx-x> is the Securities and Exchange Law article number.

In addition to the differences in the responsibilities of the SEL and CC auditors, there are important parts of the annual reports, including the audit reports, which are specifically mandated in the CC and SEL. As shown above, while the CC grants stockholders the right to discharge accountability from management and decide on dividends and officers' (director and auditor) compensation in order to protect stockholders, the SEL has the purpose of protecting investors from losses due to management fraud, thus to assure confidence and liquidity in the capital markets.

The CC requires management (the Board of Directors) to supply an annual report for the general meeting of stockholders and the SEL prescribes that management must file an annual report with the Financial Services Agency in order to supply information to investors. Figure 6-1 and 6-2 show the characteristics of CC and SEL annual reports, comparing them to U.S. reports on key points.

Figure 6-1 Contents of the Annual Report for Stockholders of Toyota and GM – ***Compared Reporting in Japan and the US***

TOYOTA	GM
97th Annual Report based on CC April 1, 2000 to March 31, 2001 *for the General Meeting of Stockholders**	2000 Annual Report January 1, 2000 to December 31, 2000 *for Stockholders thorough Web Site*
1. *97th annual meeting of stockholders notice to convene* 2. Business Report 2-1. General condition of business operations 2-1-1. Progress and result of business 2-1-2. Trend in operations and condition of property 2-1-3. Subjects to be resolved 2-2. General condition of the company 2-2-1. Contents of major business 2-2-2. Major facilities 2-2-3. Condition of stocks 2-2-4. Treasury stock acquisition and its disposal 2-2-5. Condition of the employees 2-2-6. Condition of major subsidiaries and other major business affiliations 2-2-7. Name, position, and career of directors and corporate auditors 2-3. Important events after closing day 3. *Summary Balance sheet on CC format rule* 4. *Summary Income statement on CC format rule* 5. Cancellation of stocks 6. *Surplus appropriation plan* 7. *Accounting auditor's report* 8. *Corporate Auditor's report* 9. *Documents for reference for execution of voting rights* *9-1. [1st proposal] About approval of surplus appropriation plan*	1. Financial Highlights Progress and result of business 2. Letter to Stockholders from Chairman, President (CEO), and Vice Chairman 3. Introduction Slogan 4. Design in Motion Contents of major business 5. A New Spin Contents of global business 6. Pushing Technology Contents of manufacturing technology 7. Growing Partners Introduction of Asian partners 8. Beyond Automotive Outline of new business 9. GM at a Glance Outline of affiliated companies 10. Management's Discussion and Analysis 10-1. Results of operations 10-2. Liquidity and capital resources 11. *Independent Auditors' Report with statement of responsibilities for consolidated financial statements by Chairman and President* 12. *Consolidated Financial Statements* *12-1. Consolidated Statements of Income*

9-2. [2nd proposal] About appointment of directors *9-3. [3rd proposal] About appointment of corporate auditors* 9-4. [4th proposal] About acquisition of treasury stock for stock option to offer to the directors and employees *9-5. [5th proposal] About presentation of a bonus for special services for retirement director and retirement corporate auditor* 10. Information of the merger of an accounting auditor -- Total 35 pages	*12-2. Consolidated Balance Sheets* *12-3. Consolidated Statements of Cash Flows* *12-4. Consolidated Statements of Stockholders' Equity* 13. *Notes to Consolidated Financial Statements* 14. *Supplementary Information Selected Quarterly Data (Unaudited)* 15. Corporate and Social Responsibility 16. Board of Directors name, position, and career of directors and auditors 17. Officers and Operating Executives 18. General Information -- Total 90 pages

* Toyota's summary annual report (totaling 15 pages), which is also sent to stockholders after the general meeting, is available from its website but it is little different from this report for the general meeting of stockholders. Differences appear in the (1) notice to convene the annual meeting of stockholders, (2) the surplus appropriation plan, (3) the summary of financial statements, and (4) the corporate auditor's report.

Particularly:

- in relation to (3) the financial statements, the CC annual report includes only individual financial statements but the summary annual report includes both individual and consolidated financial statements with a summary.
- in relation to (1) and (2), without closing of accounts and discharge of management's accountability through discussion and the approval of the general meeting of stockholders, the company cannot pay dividends and taxes. The general meeting must be held for individual company's stockholders and dividends and taxes are paid based on the individual company's earnings.

(GM [2000a]; Toyota [2001a])

Figure 6-2: Contents of Annual Reports for Investors of Toyota and GM
Comparative Reporting in Japan and the US

TOYOTA	GM
<u>Annual Report based on SEL; Sub-Sec. 1 of Article 24</u> April 1, 2000 to March 31, 2001 *for Investors through FSA**	<u>Annual Report pursuant to Sec. 13 of the SEA of 1934 (Form 10-K)</u> January 1, 2000 to December 31, 2000 *for Investors through SEC*
Section 1: Information about the company 1. General condition of the company 1-1. Trend of major management index 1-2. History 1-3. Content of business 1-4. Condition of affiliated companies 1-5. Condition of employees	Part 1: 1. Conditions of GM business 1-1. General information 1-2. Raw materials and services 1-3. Backlog of orders 1-4. Competitive position 1-5. Research and development

2. Condition of the business 2-1. Outline of performance 2-2. Condition of production, acceptance of order and marketing 2-3. Problems to be dealt with 2-4. Important agreements on operations 2-5. R & D activities 3. Condition of facilities 3-1. Outline of plant and equipment investment 3-2. Condition of major facilities 3-3. Programs for establishment and retirement of facilities4. Condition of submittal company (Toyota) 4-1. Condition of stock 4-1-1. Total amount of stock 4-1-2. Trend of total number and capital of issued stocks 4-1-3. Condition according to holder 4-1-4. Condition of major stockholders 4-1-5. Condition of the right to vote 4-1-6. Contents of stock options institution 4-2. Condition of treasury stock acquisition 4-3. Dividend policy 4-4. Trend of stock price 4-5. Condition of directors and auditors 5. *Condition of accounting* *5-1. Audit report for consolidated financial statements* *5-2. Consolidated financial statements* *5-3. Audit report for individual financial statements* *5-4. Individual financial statements* 6. Outline of office for submittal company's stock 7. Referential information of submittal company Section 2: Information about surety company of submittal company (None) -- Total 109 pages	1-6. Environmental matters 1-7. Seasonal nature of business 1-8. Segment reporting data 2. Properties 3. Legal proceedings 3-1. Environmental matters 3-2. Others matters (e.g., civil class action) 4. Submission of matter to a vote of security holders (None) 4A. Information of executive officers of the registrant (GM) Part 2: 5. Market for the registrant's common equity and related stockholder matters 6. Selected financial data (Unaudited): Net income based on common stock 7. Management's discussion and analysis of financial condition and results of operations 7-1. Results of operations with financial review 7-2. Liquidity and capital resources 7-2-1. Automotive, communications services, and other operations 7-2-2. Financing and insurance operations 7-2-3. Return on net assets (RONA) 7-2-4. Dividends 7-2-5. Euro conversion 7-2-6. Employment and payrolls 7-2-7. New accounting standards 7-2-8. Forward-looking statements 7A. Quantitative and qualitative disclosures about market risk 7-3. *Independent auditors' report* 8. *Consolidated financial statements with Selected quarterly data (Unaudited)* 9. Changes in and disagreements with accountants on accounting and financial disclosure (None) Part 3: 10, 11, 12, and 13. GM proxy statement for its 2001 annual meeting of stockholders Part 4: 14. Exhibits, financial statement schedule, and reports on Form 8-K -- Total 77 pages

* FSA is an acronym for "Financial Services Agency" which took over supervision of financial services except for planning of financial policy from the Ministry of Finance (MOF) in 2000. The FSA entity includes the Securities and Exchange Surveillance Commission.

(GM [2000b]; Toyota [2001b])

IV-2. Substantial Situation Surrounding the CC Corporate Auditor's Function

There is increasing concern about the CC corporate auditor's function and independence because the CC corporate auditor may not be, except in Large Companies, technically qualified in matters of financial accounting or auditing. In almost all stock companies, the nomination and selection of the directors and auditors are performed by the president from among the employees inside the company. Then the CC corporate auditor is elected at the general meeting of the stockholders.[5] Thus the CC corporate auditor, being so nominated and elected, is not viewed as independent of the president. In fact, management may presume that the CC corporate auditor is less experienced and less qualified than other executives.

Since there is no requirements or specific competence required of CC corporate auditors. Many are unfamiliar with auditing and accounting technical matters. Although the CC has revised its audit provision many times, a proposal to require an accounting professional to serve as the CC corporate auditor position, as in the U.K., has not developed. Another concern is that the CC corporate auditor position is viewed as a boon or service award within the ranks of management. Without independence and competence as an auditor, the effectiveness of the CC audit cannot be considered effective.

V. Conclusion

In this study, we compared the content and quality of Japanese and U.S. annual reports, which are the final products of the mandatory disclosure system. We continue to observe evidence which suggests that the CC audit is fundamental and influential in the governance of corporations in Japan. In part the role of tradition may explain this phenomenon since the Securities and Exchange Law (SEL) ismore recent (1948) compared with the Commercial Code (CC), which was established by the Company Act in 1890.[6]

In addition however, since indirect financing has been much more important than direct public capital market financing [that is relying on the capital markets as the principal capital formation process]. Indeed the such securities market in Japan are of only recent origins, tracing to the 1980's (Matsumoto [2001]). Thus the SEL has not been considered as important in Japan. In contrast, the CC is indispensable for establishing private companies (since it specifies such things as the tax law), so CC considerations and positioning have been relatively higher in importance than the those of the SEL.

The Japanese CC greatly values the existing owner groups/stockholders and assigns a significant task, the distribution of profit to the general meeting of stockholders. Stockholders are charged with analyzing and approving the financial statements submitted by the directors.

---

5) According to the revision of the CC in 2002, the board of corporate auditors must be composed of at least three members and must include a majority of members from outside the company (in the CC Special Rule for Large Companies).

6) The dominant relation of the CC is also apparent in the fields of law research and education in Japanese universities. The SEL is usually a minor field while the CC is a major one.

Accordingly, the CC audit system is devoted to examining the accuracy of the financial statements submitted by the directors and to report that result to the general meeting of stockholders. Though the annual meeting is often just a formality, the CC auditor also provides stockholders information about violations of other corporate requirements and stockholders can then address these concerns. The CC auditor is an agent of the shareholders and therefore has primary loyalty to protecting shareholders' profit (and does not consider the effect on other parties like the board of directors, management, or labor unions). In this instance the CC auditor's independence is determined in terms of independence from the directors

In contrast, as to the SEL audit, which incorporates a public market view reflecting the U.S., the auditor's role is to protect the financial interests of the public investor, individuals who have limited resources or opportunity discuss or approve the financial statements. The SEL auditor's independence is measured by independence from all beneficial interests. Ultimately, the SEL audit opinion about the reliability of the financial statements contributes to maintaining the liquidity of public capital markets.

The type of audit system used in corporate governance in each country, Japan vs. the U.S., depends upon which group interests— shareholders or investors — when and in what order, are to be protected. Consequently, the concept of auditor responsibility and independence is different in each country. The audit function also differs depending on society's expectations, corporate tradition and legal foundation (CC or SEL) and economic context (capital sources and financing).

Bibliography

AAA: Committee on Basic Auditing Concepts [1973], A Statement of Basic Auditing Concepts (Florida: American Accounting Association).

Carey, J.L. [1956], Professional Ethics of Certified Public Accountants, (New York: AIA).

Carey, J.L. and W.O. Doherty [1966], "The Concept of Independence – Review and Restatement," The Journal of Accountancy, CXXI, no. 1.

Carmichael, D.R. and R.J. Swieringa [1968], "The Compatibility of Auditing Independence and Management Service -- An Identification of Issues," The Accounting Review, XLIII, no. 4.

DePaula, F.C. [1986], De Paula's Auditing -- 17th edition, (London: Pitman).

Edey, H.C. and P. Panitpakdi [1956], "British Company Accounting and the Law 1844-1900," in Littleton, A.C. and B.S. Yamey, ed., Study in History of Accounting, (London: Eastern Press).

General Motors Corporation (GM) [2000a], Annual Report 2000: Fasten Your Seatbelt.

General Motors Corporation (GM) [2000b], Form 10-K report.

Japan Institute of Certified Public Accountants (JICPA) [2001], "Kansa Jisshi Jokyo Chosa" ("Investigation of Audit Practice"), JICPA News Letter, no. 98.

Previts, G.J. [1981], The Development of SEC Accounting, (California: Addison-Wesley).

Previts, G.J. [1985], The Scope of CPA Services: A Study of the Development of the Concept of Independence and the Profession's Role in Society, (New York: John Wiley).

Matsumoto, Y. [2000], "The Countervailing Power of Japanese Auditors," in Sunder, S. and H. Yamaji ed., Japanese Style of Business Accounting, (Connecticut: Quorum Books).

Matsumoto, Y. [2001], "Economical Analysis for CPA's Assurance Services – Why Was a Voluntary Audit not Required in Japan?" Review of Business and Commerce (Kansai University), no. 3.

Nihon Keizai Shimbun, Inc. (Nikkei) [1999], "Nihon-kigyo no Eibun Kansa-hokokusho 'Kokusai Kijun to Kotonaru' to Keiku" ("An English Audit Report of a Japanese Company is Different from International Standards: Legend"), Nihon Keizai Shimbun, July 28.

Sharaf, H.A. and R.K. Mautz [1960], "An Operational Concept of Independence," The Journal of Accountancy, CIX, no. 4.

Mautz, R.K. and H.A. Sharaf [1961], The Philosophy of Auditing, (Florida: AAA).

Toyota Motor Corporation (Toyota) [2001a], 97th Annual Meeting of Stockholders Notice to Convene with Annual Report [in Japanese].

Toyota Motor Corporation (Toyota) [2001b], Yuka Shoken Hokokusho (Annual Report), March 2001.

Toyota Motor Corporation (Toyota) [2001c], 97th Jigyo Hokokusho (Business Report), March 2001.

Tsuchiya, T. [1956], " 'Kanpan Ritsukai Ryakusoku' Kaidai ("Rules for Establishing a Company"), in Investigation Division of Bank of Japan ed., Nihon Kinyushi Shiryo: Meiji and Taisho-hen; (Japanese History of Finance: Meiji and Taisho Era), V.