Vol. 6 23/3/2016

IN-BRIEF INSIGHTS FINANCIAL ARTISAN http://financialartisan.com

Japanese Accounting, Audit Overhauled

Toshiba Co., an electronics manufacturing giant in Japan, triggered momentum to overhaul in Japanese system of accounting and auditing. The Financial Services Agency in Japan published on 8 March the recommendation of the Advisory Council on the Systems of Accounting and Auditing*. Material misstatements recently revealed in financial statements of Toshiba for past few years have been neglected by the audit firm, Ernst & Young ShinNihon LLC, to which an administrative order was issued by FSA last December. The order suspended EYSN from accepting new engagements for 3 months until 31 March, 2016 and required them to improve their operations.* See http://www.fsa.go.jp/news/27/singi/20160308-1.html (only available in Japanese)

5 Pillars to Ensure Credibility of Systems of Accounting and Auditing	
1	Enhance management of audit firms
2	Improve disclosure of information on accounting and auditing to shareholders etc.
3	Ameliorate skills in detecting corporate misconducts
4	Check quality of accounting audits through third party's eyes
5	Establish environment to perform high-quality accounting audits

The recommendation highlights five pillars to ensure credibility of systems of accounting and auditing. First point, to enhance management of audit firms, raises two epoch-making suggestions: introduction of a governance code like UK and the Netherlands; and development of audit firms other than Big 4. The governance code will allow major Japanese audit firms to have discretion in enhancing their governance keeping in mind principle on the code. The code is expected to be applied to not only Big 4 but also 2nd-tier firms, which will be urged to improve their operational prudence. This POV is significant and unique for Japan where Big 4 firms have engaged most of listed companies of more than 90% on a current aggregate value basis. The other four points mention: improve disclosure of information on accounting and auditing to shareholders etc.; ameliorate skills in detecting corporate misconducts; check quality of accounting audits through third party's eyes; and establish environment to perform high-quality accounting audits. Another eye-catching suggestion, which is a part of 4th pillar, presents an auditor-rotation requirement for major companies, which will be implemented in EU in June, to strengthen the independence of auditors from companies for which they perform accounting audits. This suggestion, however, remains controversial in that too frequent replacement of auditors can exacerbate quality of audits by interrupting their continuous accumulation of customized accounting knowhow.

The recommendation eloquently merits a clue to renovate Japanese auditing environment in a way to stimulate competition among firms including mid-sized ones. This movement can redraw the power map of Japanese accounting audit firms: Some will address the challenge to enhance their governance, and others, if not having resources to prepare the movement, will go into a worldwide alliance or be merged to a larger firm.