

# The Countervailing Power of Japanese Auditors\*

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## Abstract

In general theory, an auditor is asked to check an act of director in company as a part of corporate governance. Control function by each auditor is arranged in Japanese two legal institutions which are Commercial Code (CC) auditing system by auditor (Kansayaku) and accounting auditor (Kaikai-kansanin) and Securities and Exchange Law (SEL) auditing system by CPA auditor. Therefore, the business control systems are established as formal mechanisms better than other countries. But in relation with recent general contractor's corruption, an auditor took part in the malfeasance act with director rather than carried out his duty. On this account, criticism that auditor did not say what he should say has fixed. In this paper, we make clear whether such criticism is true and he performs his control function. And if he does not accomplish his function, we examine what kind of causes prevent its execution.

Auditor originally directs client's accounting procedure correctly by his authority to attach qualification to audit report. Nevertheless, in our audit for listed company, an adverse opinion and denial opinion have not been expressed, especially since 1975 when CPA auditor was introduced into CC audit and unified CC and SEL audits. We found the causes that a qualified opinion has not been expressed were following two in spite of

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above formal system.

First, while it is connected with negative (non-legitimacy) opinion in CC audit to attach qualification to his report as accounting auditor, its qualification reaches positive (qualified fair) opinion in SEL audit as CPA auditor. As a result, opposite audit opinions are expressed in unified double legal audits (CC audit and SEL audit), and it contradicts the harmonization or uniformity of both. Second, if an auditor expresses negative opinion pointing out falsehood in financial statement, the client will be delisted on the basis of stock market delisting provision

Based on above two causes, an auditor does not intend to reach negative opinion, but enforces to transfer negative opinion to positive opinion by himself. Even if Japanese auditor can attach qualification to his report, as a result of such self-enforcement, he cannot help relieving his all negative qualifications to No.2 affirmative exception (for accounting change with justifiable reason). In short, we can understand the auditor's countervailing power is restricted. By this restriction, even if there is conflict between auditor and client, the auditor himself amends his own opinion into client's receivable level and both parties tend to maintain the contract relation. Therefore the opinion shopping has never happened explicitly in Japan.

In summary, Japanese audit system has the following special features. (1) While the auditor has the legal authority to freely exercise his right to express the audit opinion he considers appropriate, his economic incentives attenuate the actual exercise of this right. Auditor's business affiliation with the client, and the interaction of audit opinion with other laws and regulations diminish auditor's bargaining power. (2) When a disagreement arises between the auditor and his client, both try to maintain their organizational relationship by internalizing the change (e. g., replacement of auditor in auditing firm).

Keywords : Commercial Code audit, Securities and Exchange Law audit, Kansayaku, Kaikei-kansanin, Non-legitimacy or legitimacy opinion (in CC), Adverse, Qualified fair, or Unqualified opinion (in SEL), Opinion Shopping, Bargaining range, Uniformity or harmonization of double legal audits, Affirmative qualification, False statement, Delisting provision.

### Introduction

For several years, many demands have been made, both from outside as well as inside the country, for strengthening the control function in Japanese corporate governance. The demands were followed by a revision of the Commercial Code to reinforce the institution of auditing and to simplify the process of filing class action suits by stockholders. A corporation has three organs — shareholders, the board of directors, and Kansayaku (inside) auditors. These revisions were confined to these three organs, and did not sufficiently strengthen the control function. In an article entitled “certified public accountant saying nothing” (Nikkei Business [1992]) demanded that the audit functions of the independent CPAs should also be strengthened. But no such actions were taken.

In this environment, the responsibility to discipline auditors was transferred from the government (the Business Accounting Deliberation Council in the Ministry of Finance) to the Japanese Institute of Certified Public Accountants (JICPA) in the private sector. Pronouncement of guidelines on three audit operations was their attempt to deal with the scandals that occurred during the preceding few years. However these guidelines concern the process of audit only, and not the auditor.

Auditing standards in Japan were established in 1950, and contemporary financial statement audit as “regular audit” was begun six years later in December, 1956. At that time, it was stated that “the time when we should have enforced ‘regular financial statements audit’ had come, because audit practice had matured progressively with the development of business accounting institution.” Newspapers alleged that, once a auditor as acquired an audit client, the development of a personal relationship between the auditor and the client will make it difficult to change the audi-

tor. Eagerness of the auditor to retain the client will distort their bargaining powers, weakening the ability of the auditor to exercise his own independent technical and business judgment in rendering his audit opinion. Thus the JICPA was alleged to have merely skimmed the surface of the problem by confining itself to the questions of audit process, instead of going to the heart of the matter that concerns the auditor-client relationship.

In this paper, we shall examine whether, in light of JICPA's actions, auditor has become a captive of the client, or is a professional who exercises his own independent technical judgment with equal negotiating power. For this purpose, we have chosen the problem of opinion shopping by client firms induced by the prospects of qualified opinion.

In Japan virtually all qualified audit opinions concern the break in continuity due to "justifiable reasons" (the so-called No.2 qualified opinion). Few No.1 qualifications are issued. Virtual abandonment of No.1 qualification, which is the strongest tool in the hands of the auditor, diminished the social value of the audit system itself. Accordingly, we first examine why most qualified opinions in Japan fall into Category 2 (substantial additional note). Next, we examine the auditors' bargaining power in Japan by comparing our sample with the U. S. sample of auditor replacements that resulted from qualified opinion. Finally, we analyze the Japanese cases of No.2 qualified opinion and auditor changes.

### I. Qualified Opinion No.1 in Japan

Auditing opinion in Securities and Exchange Law (SEL) audit consists of three discrete opinions that are aggregated into a single opinion about the overall fairness of the financial statements. Working Rules of Reporting No.3-(3) require the auditor to express three sub-opinions in the discrete opinion division:

- (1) Whether the accounting policies adopted by the business enterprise are in conformity with generally accepted accounting principles (conformity with GAAP — No.1 exception / qualification).
- (2) Whether the business enterprise applies the accounting policies consistently with those of the preceding year (observance of consistency principle — No.2 exception / qualification).
- (3) Whether the presentation of the financial statements is in conformity with generally accepted principles concerning presentation of financial statements (conformity with GAAP concerning presentation of financial statement — No.3 exception / qualification).

After expressing these three separate opinions, an auditor will express his overall opinion about the fairness of the financial statements as a whole on the basis of these three components. If no exception (qualification) exists in any the three dimensions, an unqualified (fair) opinion report called “standard model for auditor’s report” by JICPA is prepared. If, on the other hand, any one or more of the three discrete opinions is qualified, the auditor must consider its effect on the fairness of the financial statements as a whole, and then render a qualified opinion or fairness, or deny his opinion.

#### I - 1. Theoretical Shift Form of Audit Opinion

After gathering evidence that forms a reasonable basis, auditor may choose to render an unqualified, qualified, or adverse opinion on each of the three discrete components. How do they influence the overall audit opinion? These three levels of certification may apply to each of the three discrete categories discussed above. If the auditor finds an error in the financial statements, he cannot issue an unqualified opinion unless the error is corrected. The uncorrected errors affect the fairness of the financial

statements.

(1) *Conformity with GAAP*

The No.1 qualified opinion prescribed in Working Rules of Reporting 3(3)1 will be expressed about whether the accounting policy adopted by business complies with GAAP. If the accounting policy violates the accounting standards, the auditor mentions (1) the existence of the exception, (2) the reason for this judgment, and (3) the effect of the exception on the financial statements.

(2) *Consistency*

The No.2 qualified opinion prescribed in Working Rules of Reporting 3(3)2 is rendered about whether the accounting policy adopted by a business is consistent with the policy used in the preceding years. When accounting policy is changed, the auditor must also mention, whether the reason given for the change is justifiable, and the effect of the change on the financial statements.

(3) *Conformity with GAAP concerning presentation of financial statement*

The No.3 qualified opinion prescribed in Working Rules of Reporting 3(3)3 is expressed about whether presentation of financial statement meets the generally accepted presentation standards concerning the form and content of financial statement (the financial statement rule ; Zaimushohyo Kisoku). When the regulatory requirements are not met, the auditor should mention this fact, point out the violation, and show the corrections.

Finally, the overall opinion is expressed on the basis of the degree of materiality of any exceptions in each of the three abovementioned discrete opinions. The final opinion may be qualified, adverse, or unqualified.

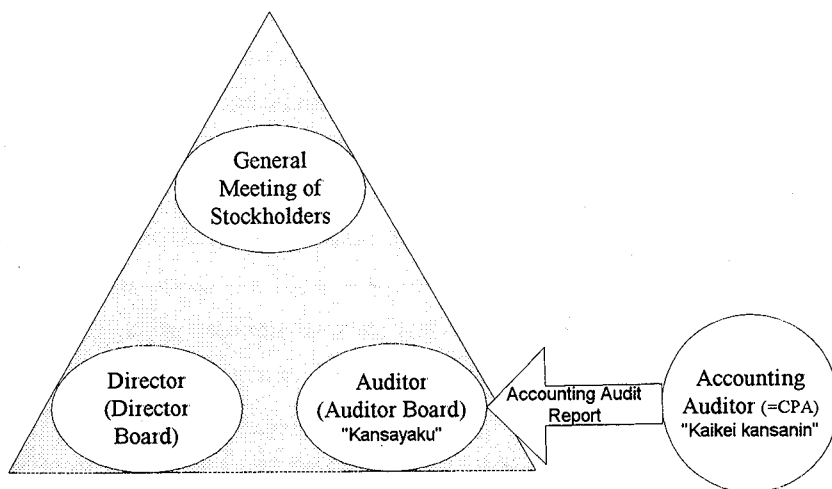
In deciding whether the overall opinion should be unqualified, qualified, or adverse, the auditor must consider materiality. Theoretically, two separate materiality thresholds are used, one for the discrete opinions, and

another for the overall opinion given certain exception(s) in the discrete opinions.

Thus the SEL audit gives the auditor the right to express a negative opinion if he finds the financial statements of firm inappropriate. This right induces the client firms to stay close to the permissible accounting standards.

### I - 2. Auditor's Opinion in Commercial Code Audit

The above section describes the SEL audit. However, in Japan there is also a second kind of audit called Commercial Code (CC) audit. The CC audit applies to all joint stock companies. A Commercial Code Exception (“Shouhou Tokurei Hou”) requires that the larger joint stock companies (so-called “Dai-Gaisha”) also have an audit by outside CPAs. The CPA auditor (accounting auditor[“Kaikai Kansanin”]) prepares the accounting



(Exhibit 1: Three Organs of Joint-stock Company in CC)

part of the audit report for consideration by the CC auditor (“Kansayaku”). The contents of audit report prepared by CC auditor are described in Sub-Section 2 of Commercial Code Article 281-3.

According to Commercial Code Exception, the opinion of the accounting auditor should be related to No.1-7, 9, and 11 in Sub-Section 2 of Commercial Code Article 281-3:

1. Scope of audit
2. When the matters as required in the company’s books have not been so stated, or untrue statements are made, or when the statements in the balance sheet or the income statement do not conform to the statements in the accounting books, state such fact.
3. When the balance sheet and the income statement fairly state the financial position and the results of the operations of the company in violation of the related laws and the articles of incorporation, this fact should be stated.
4. When the balance sheet or the income statement is not fairly stated, and the financial position and the results of operations of the company are in violation of the related laws and the articles of incorporation, such facts should be stated including the reasons why.
5. Whether the change of accounting policy for preparing the balance sheet or the income statement are proper, and the reasons why.
6. Whether the accounting matters to be stated in the business report are correctly stated in accordance with the related laws and the articles of incorporation.
7. Whether the proposed appropriation of retained earnings is in accordance with the related laws and the articles of incorporation.
8. Omitted.
9. When the matters which should be stated in supporting schedule of



Article 281 Sub-Section 1 [preparation of accounts] have not been stated, or when there is a misstatement or a contradictory statement to the statement in the accounting records, balance sheet, income statement or business report is made, this fact should be stated.

10. Omitted.

11. When the necessary examination for auditing could not be completed, state that fact and the reasons why.

These provisions of the Commercial Code require the auditor to express audit opinion concerning matters covered in SEL audit. However, the main point of the CC audit is an opinion about legitimacy of accounts. For example, consider some typical opinions (First Auditing Committee [1982]):

(1) *Opinion about Legitimacy (No.3 or No.4 opinion)*

The legitimacy (No.3) opinion will be expressed if accounts comply with decree and article of incorporation. On the other hand, if the auditor recognizes that the matter violated in part exists, he will express non-legitimacy (No.4) opinion. This legitimacy opinion is not expressed to make clear degree of conformity of accounts with decree and article of incorporation as a whole; but if there is only a negative element in accounts, its purpose is to show such element to the stockholder as a reader. In other words, the overall opinion of the SEL audit that makes the degree of reliability (fairness) of financial statement clear to the reader as an investor does not exist in CC audit. The CC audit is intended to help the stockholders decide whether to approve the company accounts in its general meeting by providing them the audit report for reference. Even if the CC audit report expresses No.4 (non-legitimacy) opinion, the accounts will be closed, if general meeting of stockholders deliberates and approves such

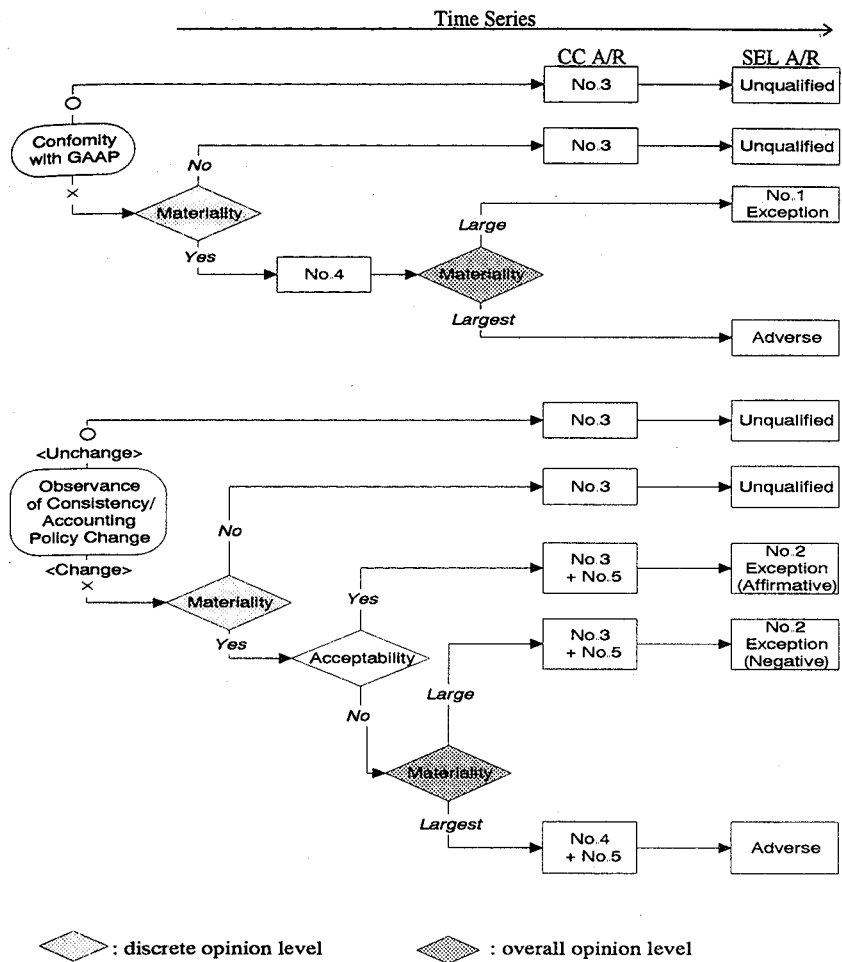
accounts.

(2) *Opinion about Change of Accounting Policy (No.5 Opinion)*

When a firm changes its accounting policy, No.5 opinion asks the accounting auditor to judge whether it is acceptable, and to state his reason for such judgment in his report. As a result, when an accounting policy is changed, whether it is acceptable or not, an auditor has to state the details of such change, whether that change is acceptable, and reason for his judgment in his report. When an auditor does not accept such change, and it is judged to have a serious impact on balance sheet or income statement, he should express No.4 (non-legitimacy) opinion.

I - 3. Coexistence of SEL and CC Audit Reports

The two audit reports take different forms because they have different premises, purposes, and constituencies. CC audit opinion becomes decision making data when general meeting of stockholders approves the accounts prepared and submitted by company's directors. On the other hand, SEL audit takes approval accounts as a given, and concentrates on ensuring that the data in the financial statements are useful for making investment decisions. It would not be advantageous to eliminate merge the two kinds of opinions into one. Exhibit 2 shows their theoretical forms.



(Exhibit 2: Theoretical Correlation among Audit Opinions)

According to this figure, a No.4 (non-legitimacy) CC audit opinion is not theoretically inconsistent with a qualified (fair) opinion in SEL audit report. The latter is included to a category of [affirmative] fair opinion.

Consistent with this general opinion, JICPA apparently distinguishes the CC audit from SEL audit and emphasizes an identity of each legal audit. It designates in its guideline that whether SEL overall opinion becomes qualified fair or adverse depends on the materiality basis for overall opinion formation in SEL audit when No.4 (non-legitimacy) opinion is stated (First Auditing Committee [1989]<sup>(1)</sup>). It is clear from the above that JICPA's position is hardly different from the lay opinion in this matter. Nevertheless, few listed companies in Japan have received adverse as well as qualified opinions since 1975. This suggests that some factors induce the auditor to be reluctant to issue qualified opinions. Such factors may weaken the countervailing power the auditors may have against the audited corporation.

#### I - 4. Restriction of Countervailing Power against Audited Corporation

As explained above, SEL audit is designed to ensure that the financial reports provide information for the investors. Auditor does so by making suggestions to the client firm, with the implicit or explicit threat of qualification to bolster his bargaining power. On the other, the power of the CC auditor lies in his ability to put a brand of non-legitimacy on the accounts placed before the general meeting of stockholders who decide on acceptability of the accounts. In other words both audits have different purposes. Even if an audit field work by CPA (as SEL auditor and CC accounting auditor) was shared under the title of "substantial uniformity [between SEL and CC audit]<sup>(2)</sup>," at the final stage of expressing opinion separately in

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(1) This committee report is a partly revision of the First Auditing Committee Report No. 40 "Treatment of Audit Report in relation to Commercial Code Audit," (First Auditing Committee [1982 a]) and No. 41 "'Form' of Commercial Code Audit Report," (First Auditing Committee [1982 b]) It is affected by the revision of requirement to state the "performance of business group" in Business Report in CC.

formal, the independent relationship is demanded on the theory and legal institution.

Companies listed on Tokyo Stock Exchange must obey its Stock Certificate Delisting Standard Article 2 Sub-Section 1 No. 9 “False-Statement of Financial Statement or Interim Financial Statement.” It provides for delisting of stock when a company makes a false statement in annual or interim financial statements that is deemed by the Exchange to have a serious impact. False statement is defined as follows: it is “....., the case when ‘adverse’ or ‘denial’ opinion is expressed by CPA or auditing firm as overall opinion in audit report” (2(7)a-(a)). The part to be paid attention is that the false statement in financial statement comes under the case when CPA expresses an adverse or denial opinion (unequal to false statement [misstatement] strictly) *as overall opinion*. In other words, according to the wording of these standard and treatment only, we can not interpret the just a qualification is connected directly with the delisting from the Stock Exchange. But why has everyone understood “CPA could not express the qualified opinion because his client would be delisted if he attached a (negative) qualification on audit report” generally.

There is no disciplinary punishment for audit qualification for a company other than the possibility of being delisted. The possibility of delisting of client makes the auditor extremely reluctant to attach qualification to his report.

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(2) Unless the “substantial uniformity between SEL audit and CC audit” were achieved, the “large company” would have to pay double audit fees to a single CPA or auditing firm as CC accounting auditor besides SEL auditor.

	1~6/ '72	7~12/ '72	1~6/ '73	7~12/ '73	1~6/ '74	7~12/ '74	1~6/ '75	7~12/ '75	1~6/ '76	7~12/ '76	1~6/ '77	7~12/ '77	1~6/ '78	7~12/ '78	
Fair	Unqualified	476	468	491	448	409	429	414	181	433	249	527	256	543	183
	Qualified (Affirmative)	85	89	95	135	172	138	120	69	168	71	161	62	148	125
Opinion	Qualified (Negative)	119	111	121	112	137	126	82	2	5	1	2	0	3	0
	Unqualified Nearly	2	2	1	0	0	0	0	0	0	0	0	0	0	0
Unfair	Adverse	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	Denial	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total	682	670	708	695	718	693	616	252	606	320	690	318	694	308	

Exhibit 3 : Classification of Overall Opinion

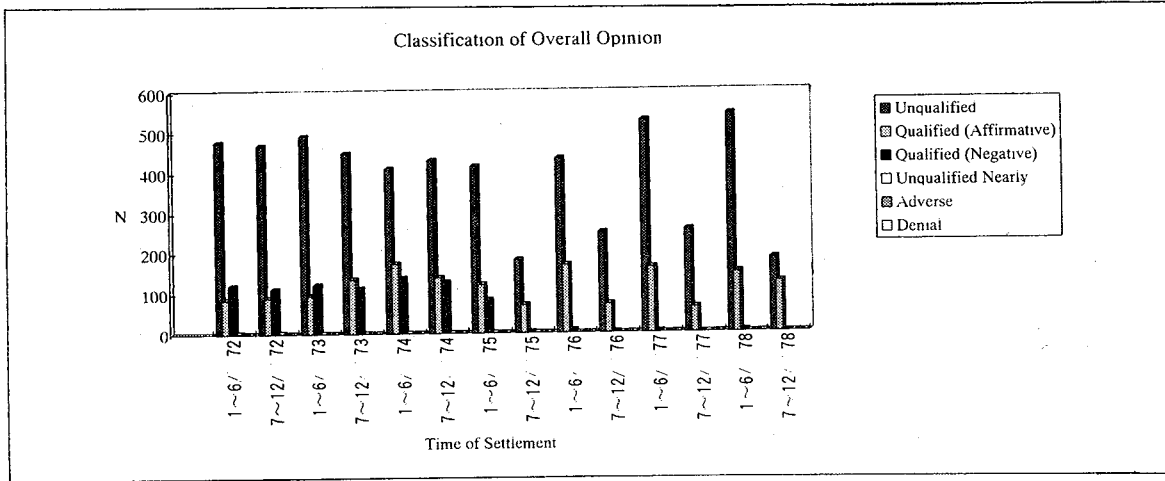


Exhibit 3 is a classification of audit opinions for a few years before and after 1974 when Commercial Code was revised, and accounting audit by CPA was introduced<sup>(3)</sup>. It is clear from the table that the number of qualified (fair) opinions issued decreased sharply following the introduction of CPA as the CC accounting auditor. One possibility is that the decline in the number of qualified opinions reflects the effect of introducing the CPAs as CC accounting auditors. “The time when our CPA audit which started as SEL audit got effective substantially was after introduction into CC audit (accounting auditor audit by Commercial Code Exception).....” (Murayama [1992] p. 47). Behind this view, there was the following fact: “There was an agreement between [JICPA] and economic society [Keidanren] that prescribed to refrain from the main office audit until expiring the closing accounts before CC revision in 1974. And so, when the period end audit was begun, the accounts was not able to be corrected because they were already in printing process.” “There was no influence on preparing financial statement although a period for certification of financial statement included in securities report [Yukashouken Houkokusho] was provided long enough” (Murayama [1992] p. 51). As a result, “in order to make CPA audit effective practicably and to represent business financial affairs fairly, it was necessary that the CPA audit opinion should be respected and have an effect on preparing accounts process on CC” (Yasui [1967] p. 46).

However as pointed out since those days, “the measure for making CPA audit effective practicably on SEL is naturally a different problem from introducing CPA audit into CC audit” (Yasui [1967] p. 45). The situation that SEL audit had “no influence on the preparing accounts process of company,” mentioned above, did not require any changes among two

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(3) We prepared this table from *Shouken* edited and published by Tokyo Stock Exchange.

legal audits relation. In other words, it was demanded a SEL measure reinforcing SEL auditor's instruction ability during both intermediate and term end (settlement) audits, rather than an adjustment or unification of CC audit and SEL audit by introducing CPA (SEL auditor) into CC audit for "large company" as an accounting auditor in 1974 CC revision. Firstly because of the understanding to consider the economic society, "that main office audit is withheld until expiring the closing accounts" was aberrant, they should have removed such understanding, and made CPA audit effective by guaranteeing SEL auditor's influential instruction on fair financial report. Ministry of Finance, which regulated SEL audit, and the Ministry of Justice, which regulated CC audit, might have thought applying CPA audit to smaller firms was unnecessary.<sup>(4)</sup>

At the same time when CPA audit in SEL taken into CC audit for "large company," the phrase of "substantial uniformity of both legal audits" has begun to go out alone. And so not only on audit field stage but on report stage the establishing same level of materiality judgment was needed. With respect to the larger companies listed on the Tokyo Stock Exchange, a strange logic was used: "Social confidence of audit will be injured if a fair opinion of qualified fairness (=affirmative opinion) is expressed in SEL with non-legitimacy opinion (=negative opinion) expressed in CC audit." In other words, if the CPA expresses a negative opinion in CC and an affirmative opinion in SEL through a unified audit (see Exhibit 2), such opinion will cause too much dissonance, and will be socially unacceptable. Therefore, the argument goes, the auditor himself should enforce

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(4) In general it is said actually that non-legitimate opinion is expressed for the company that is not under such dual regulation by SEL and CC and that is non-listed on the Stock Exchange and only CC audit is applied. And, generally it is said also that qualified opinion is expressed for the companies on over-the-counter market which only SEL audit is applied.

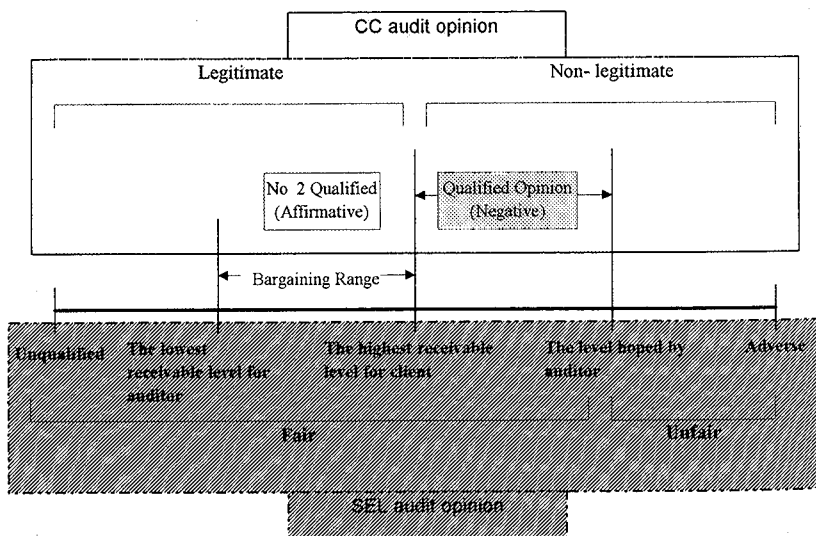


to refrain from expressing qualified opinion in SEL audits

If the abovementioned situation arose from uniformity between CC and SEL audits, ambiguity of “false-statement” concept in TSE’s delisting provision is another possibility. The concept of “false-statement” is equally applicable to all misstatements, independent of whether they arise from error or deliberate intention. All companies with misstatements in their financial reports become equal candidates for delisting. But, because the Exchange needs an evidence which is enough to be considered as “falseness” before delisting a company, it shall demand it from audit opinion. In other words, the objective of the delisting provision is not simply to interpret every adverse opinions as evidence of falsehood in the financial statements; only negative part of audit opinion (qualification) are to be so interpreted statement, —non-legitimacy opinion on CC—. It is clear that audit qualification does not imply false statement. The degree of qualification has a serious impact on the overall opinion because “Treatment for Listing Standards” 2(7)a-(b) also considers a securities report which receives a correction order from the Ministry of Finance as a report including false-statements. In fact, a correction order for false-statement etc. by the Ministry of Finance is issued to the financial statement (securities report) which does not result in adverse or denial overall opinion.

In either case, when an auditor is faced with the prospect of having to express No.1 qualification, he would naturally try to persuade the client to appropriately amend the financial statements first. Even if the client does not agree entirely, there might be room for reaching a compromise position that avoids the non-legitimacy opinion. All this is possible so long as the transgression is not serious in terms of materiality at the overall opinion level. By taking a hard line, the auditor will only force his client to be delisted.

Therefore, the CPA can find himself in a situation where he cannot express a natural qualified opinion, and the materiality basis in the formation of the audit opinion referred to in Figure 1 becomes substantially dysfunctional at the discrete opinion level (except a change of consistency with justifiable reason). In summary, the range of qualified opinion that



Cf. Krishnan, Jagannathan, *Auditor Switching, Opinion Shopping and Client Size*: Ph.D. dissertation (Ohio State Univ.: UMI, 1991), pp. 37-38

Note:

- (1) The (SEL) adverse level is not able to be used by SEL auditor because adverse opinion is connected with delisting of his client directly.
- (2) The (CC) non-legitimacy level can not be used by CC accounting auditor because it might arrive at (qualified) fair opinion and be against "uniformity of both legal audits."
- (3) In the result, (SEL) CPA auditor is only entitled to bargain with his client in the range between fair opinion in SEL audit and legitimate opinion in CC audit -- "No 2 qualified opinion with justifiable reason [SEL] (=acceptable accounting change [CC])" --

(Exhibit 4: Bargaining Range based on the Uniformity between SEL and CC Audits)

should become the greatest countervailing power for CPA—bargaining range—becomes extremely narrow (see Figure 2). It is hardly surprising, then, that virtually all post-1974 qualified opinions are negative in sharp contrast to the data from the pre-change period.

The two factors we discuss next are related to the problem of how the security markets deal with the coexistence of this negative (non-legitimacy) opinion and affirmative (qualified fair) opinion.

## II. The Appearance Pattern of Qualification in the U. S.

### —For Comparison of Japan and U.S.—

There have been many investigations of the relationship between expression of qualified opinion and change of auditor. In U. S., in particular, this question is related to opinion shopping. Opinion shopping is defined as “the search for an auditor willing to support a proposed accounting treatment designed to help a company achieve its reporting objectives even though that treatment might frustrate reliable reporting” (FRR # 31: SEC [1987]). Let us examine two approaches to the relationship between expression of qualified opinion and replacement of auditor.

#### *Negative View against Existence of Opinion Shopping*

The first systematic study in the U. S. was done in 1967 by J. C. Burton and W. Roberts. This period is before indirect disclosure regulation on temporary report (Form 8-K) in 1971 and 1974 and direct disclosure regulation on annual report (Form 10-K) enforced. Therefore, it is parallel to the current situation in Japan in which replacement of auditor is not constrained by special disclosure, only by the disciplinary bylaws of JICPA.

Burton and Roberts extracted 620 companies from the Fortune's 500 list in the years 1952 through 1965, “both because they control a substan-

tial proportion of the country' resources and because their economic power over public accounting firms is potentially the greatest" (Burton and Roberts [1967] p. 32), and examined all auditor changes for this sample (see Exhibit 5). They found 83 replacements in which completely new auditors were appointed (approximately 13 percent of the 620 companies), and sent questionnaires to their executives and accountants to find out the reasons for change. They also collected their annual reports. Exhibit 6, taken from Burton and Roberts (p. 34), shows the reasons given :

Changes due to merger of public accounting firms		54	
Changes initiated by the industrial corporation			
Large accounting firm to large accounting firm	39		
Small accounting firm to large accounting firm	31		
Small accounting firm to small accounting firm	8		
Large accounting firm to small accounting firm	5	83	
			137*

\* 8 companies changed auditors twice. 121 companies changed auditors once

Note

"Large accounting firm" refers to the 8 largest national firms: Arthur Andersen & Co., Arthur Young & Company, Ernst & Ernst, Haskins & Sells, Lybrand, Ross Bros & Montgomery, Peat, Marwick, Mitchell & Co., Price Waterhouse & Co., Touche, Ross, Bailey & Smart

(Exhibit 5: Auditor Changes 1952-1965)

Reason for change	Type of Change				Total
	Large to Large	Small to Large	Small to Small	Large to Small	
Management change	21	7		2	31
Take-over of control by other corp	2	1			3
Decision by U. S. government				1	1
Need for additional services	5	11		1	17
Dissatisfaction with services offered	4	1			5
New financing		8		1	9
Accounting principles dispute	2	1		1	6
Regular rotation policy	1				1
Personal: to follow one man				2	2
Retirement of sole practitioner		1			1
Undeterminable	4	1		1	7
Totals	39	31	8	5	83

(Exhibit 6: Principal Reasons for Auditor Switches)

The data shows that executive changes in the client firm are the single factor to which most changes are attributed. In only six cases is a dispute about accounting policy given as the reason for change. Accordingly, the authors concluded that "this examination of the reasons for auditor changes offers no evidence that any threat to the proper exercise of the attest function exists". And they denied the fear that a homogeneity of CPA providing services and a competition among accounting firms bring about the fee structure or willingness to accept a looser interpretation of accounting principles (Burton and Roberts [1967] p. 35).

*Positive View for Existence of Opinion Shopping*

While Burton and Roberts did not find much evidence for opinion shopping, Chow and Rice [1982] affirm the existence of opinion shopping caused by the threat of qualified opinion. They followed up on what happened to the auditors who expressed a qualified opinion. They extracted companies which changed auditor from Leasco Disclosure Journal of 1973 and 1974 fiscal years (see Exhibit 7), and tested the association between auditor changes and qualified opinions using a chi-square test. They found that replacement is not independent of a qualified opinion received.

	<u>Qualified</u>	<u>Unqualified</u>	<u>Total</u>
Auditor change	141	277	418
Auditor unchange	991	8,051	9,042
Total	<u>1,132</u>	<u>9,328</u>	<u>9,460</u>

(Exhibit 7: Qualified Opinion and Auditor Changes)

It is easy to verify from this table that the only statistically significant variable in this equation is qualified opinion.

In addition, they used the variables identified by Burton and Roberts

as independent variables in the following regression equation in which auditor change was the dependent variable :

$$S = a + b_1Q + b_2Mg + b_3Mr + b_4N + b_5X$$

$S$  = auditor change (1)/no change (0)

$Q$  = receive a qualified opinion (1)/receive an unqualified opinion (0)

$Mg$  = executive change (1)/no change (0)

$Mr$  = merger occurrence (1)/non occurrence (0)

$N$  = new finance (1)/no finance (0)

$X$  = indicate other reason about auditor change (1)/no indication (0)

Student's t-tests on the estimated coefficients of this regression equation yielded the following t-statistics : (see Exhibit 8).

<u>Variables</u>	<u>T-Score</u>
Qualified	2 6589
Management change	-0 0006
Merger	-0 4872
New Financing	0 6884
etc.	-0 0004
Intercept	-8 2712

(Exhibit 8: Auditor Changes and Related Variables)

In addition, the technical capability to audit the large international operations, and the reputation of larger audit firms is often given a reason for switches to such audit firms<sup>(5)</sup>.

### III. Accounting Policy Change and Auditor Replacement in Japan

When we look for the existence of opinion shopping in Japan, we must remember that auditors in Japan have an extremely narrow bargain-

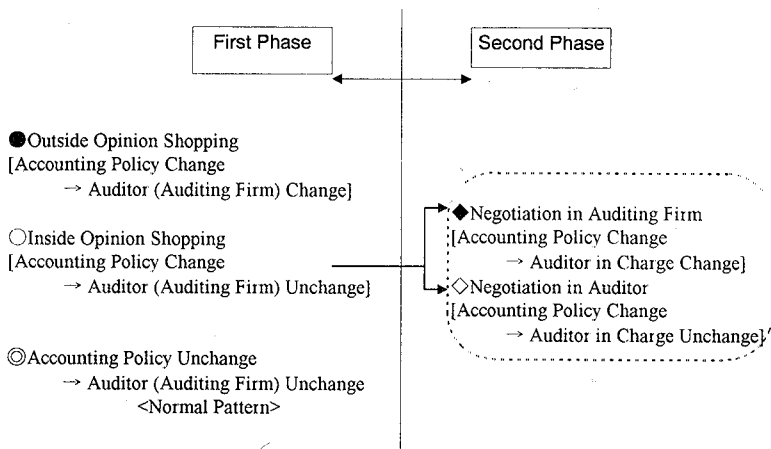
(5) See Carpenter and Strawser [1971], Bedingfield and Loeb [1974], and Healy and Lys [1986].

ing range; for the reasons discussed earlier, any intentions of issuing qualified opinions are rarely carried out. This forces us to focus our investigation on the expression of No.2 qualified opinion of accounting policy change on the basis of justifiable (affirmative) reason. We try to examine the existence of opinion shopping in Japan by analyzing the connection between auditor changes and No.2 qualified opinion, as follows.

### III - 1. Appearance Pattern of Opinion Shopping

We can think about two sides of opinion shopping. First, a replacement in auditor following an accounting policy change may be interpreted as a consequence of auditor's dissatisfaction with the change, even though the auditor signed an affirmatively qualified audit opinion (result in qualified fair opinion). On the other hand, an accounting policy change which is not followed by a switch in auditor may suggest that the auditor's affirmative qualification was genuine, not forced, (result in unqualified opinion), even if the No.2 (affirmative) qualified opinion may have been the result of some negotiation and bargaining with the client (resulted in No.2 qualified opinion)<sup>(6)</sup>. Such opinion shopping with two dimensions is consistent with the scheme shown in Figure 3.

(6) Not with No 2 opinion, we think that the example of typical opinion shopping on the basis of the original (negative) qualification was an auditor change (dismissal) in Gajoen Kanko Co. This company is out of following analysis to be irregularity (February) settlement of accounts. As outwardly there is outside auditor change (auditing firm → individual), this is the sample that associated partner personally has tried to continue the audit in the inside. Subsequently as it was impossible that an auditor as a partner withdrew from his auditing firm without special reason (CPA Act Article 34-17), the auditor himself in charge switched finally. And so, its case became complete outside change on a result, it was caught as the unusual state in our country. It was the phenomenon that could not be produced unless there was "an extreme strain under which that company would become delisting from the Stock Exchange largely" (Toba [1993] p. 30). We can understand that the outside auditor change is how peculiar in our country from this fact.



is showing the fact that an auditor in charge changed in auditing firm or an auditor made a compromise in his mind -- inside negotiation -- with his client, even if outside auditor (auditing firm) change did not occurred apparently

(Exhibit 9 : Appearance Pattern of Opinion Shopping)

III - 2. Actual Circumstances of No.2 Qualification and Auditor Change

Exhibit 10 shows the March settlement companies listed in Tokyo Stock Exchange First Market classified by the presence of No.2 qualification and auditor changes.

Mar. 1989	No. 2	Unqualified	Total	Mar. 1990	No. 2	Unqualified	Totale
	Qualification				Qualification		
Unchange	103	636	739	Unchange	145	590	735
Inside Change	14	154	168	Inside Change	30	153	184
Outside Change	10	9	19	Outside Change	4	8	11
Total	127	799	926	Total	179	751	930

(Exhibit 10 : Association No.2 Qualification and Auditor Change)



March, 1989		March, 1990	
Auditor Unchange (Inside)		Auditor Unchange (Inside)	
Increase of Associated Partner: 2→3	4	Increase of Associated Partner: 2→3 Increase of Associated Partner: 2→3 (remain 1 among 3) Increase of Associated Partner: 3→4 Increase of Associated Partner: 1→2	11 3 2 3
Switch of Representative/ Associated Partner: 1 among 2	2	Switch of Representative/ Associated Partner: 1 among 2	2
Switch of Representative/ Associated Partner: 1 among 3	2	Switch of Representative/ Associated Partner: 1 among 3	3
Switch of Representative/ Associated Partner: 2 among 3	1	Switch of Representative/ Associated Partner: 2 among 3	1
Switch of Representative/ Associated Partner: 1 among 4	1		
Decrease of Associated Partner: 2→1	1		
Decrease of Associated Partner: 3→2	1	Decrease of Associated Partner: 3→2 Decrease of Associated Partner: 4→3	3 1
Unmajors 5 ("Shinyo"): 1→2	1	Unmajors 5 ("Inoue"): 1 among 2	1
Merger among clients ("Century Auditing Co" → "Century Auditing Co"): Associated Partner Remain 3 (acquisition side auditors)	1		
<b>Auditor Change (Outside)</b>		<b>Auditor Change (Outside)</b>	
<b>Merger among Auditing Firms:</b>		<b>Merger among Auditing Firms:</b>	
"Shinkou"→"Chuou-Shinkou": Associated Partner Remain 2 + New 1	2		
"Shinkou"→"Chuou-Shinkou": Switch Associated Partner 1 among 3	1		
"Chuou"→"Chuou-Shinkou": Associated Partner Remain 2 + New 1	1		
"Chuou"→"Chuou-Shinkou": Switch Associated Partner 1 among 3	1		
"Nishikata"→"Toumatsu": Switch Associated Partner 1 among 2	2		
"Touyou"→"Asahi-Shinwa": Associated Partner Remain 2	1	"Yokohama-Sekiuchi"→"Asahi-Shinwa": Associated Partner Remain 2 + New 1 (b)	1
"Shinkou"→"Outa-Shouwa": Associated Partner Remain 2 (a)	1		
Personal Firm: Decrease 2→1	1	Personal Firm: Switch 1 among 2 Personal Firm: Decrease 2→1	2 1

- (a) The CPA quitted "Shinkou" and entered "Outa-Shouwa"
- (b) The CPA quitted "Yokohama-Sekiuchi" and entered "Asahi-Shinwa"

Note: "Chuou" and "Shinkou" merged into "Chuou-Shinko" (renamed to "Chuou")  
 "Nishikata" and "Toumatsu-Aoki" merged into "Toumatsu-Aoki" (renamed to "Toumatsu")  
 "Asahi" and "Shinwa" merged into "Asahi-Shinwa" (renamed to "Asahi")  
 "Outa" and "Shouwa" merged into "Outa-Shouwa"

(Exhibit 11: Shifting Situation of Auditors Attaching No.2 Qualification)

Exhibit 11 shows the shifting situation of auditors that attach No.2 qualification in Exhibit 10.

It is clear from Exhibit 10 and 11 that the incidence of inside replacements exceeds the outside replacements by an order of magnitude. In the few outside replacements that do occur, most cases involve merger of audit firms. In some cases, the client moves his business when the person in charge of the audit changes firms. In any case, we can see little evidence of auditor replacements motivated by accounting disagreements with the client, or those originating in the auditor's decision to issue a No. 2 qualification (accounting policy change). Therefore, it seems reasonable to conclude that opinion shopping in the form of outside replacement does not occur. There is little correlation between outside replacement of auditor and expression of No.2 qualification (accounting policy change).

### Conclusion

(1) Since their introduction in Japan, auditing standards have been used to ensure the financial soundness of firms. Smoothing income through changes in accounting policy has not been viewed as income manipulation. Therefore income smoothing is approved as a "justifiable reason" for accounting changes and appropriate for No.2 (affirmative) qualified opinion. If the audit client satisfies the auditor that the accounting change is consistent with the goal of keeping financial soundness of the firm, and producing an adequate amount of income for the period, it becomes a candidate for affirmative No.2 qualification. The auditor has only a narrow bargaining range to work with in such negotiations.

(2) The auditor's right to express a qualified opinion on SEL audit gives him leverage to direct the client's accounting policy. If the financial statements do not provide reliable information for the investor, and the

client does not make the changes he suggests, the auditor can qualify the financial statements. However this bargaining power the auditors were supposed to have has been diminished by two factors: (1) the tendency to harmonize the SEL and the CC audit opinions, and (2) the pressure on the auditor to avoid becoming responsible for delisting of the client from the Tokyo Stock Exchange whose delisting rules depend on the audit report.

(3) The auditor does not drive audited corporation into crisis of delisting by issuing a negative qualification (especially No.1 qualification) in the discrete part. Instead, he fulfills his duty by issuing a No.2 qualified opinion in audit report (formal qualified fair opinion). On the other hand, the audited corporation can obtain an opinion of whole financial statements being fair (substantial unqualified opinion) and can thus conform to the rules of TSE, MOF, etc..

(4) Knowing the Japanese conditions, we did not really expect to find many outside auditor changes. Tables 6 and 7 support that expectation. A few cases of outside auditor change that did occur were occasioned by merger of auditing firms; these were not attributable to disputes about accounting policy. The association between audit qualification and auditor changes, as observed in U. S., may not occur in Japan. While opinion shopping in U. S. may occur across audit firms, in Japan it may occur within the audit firm across individual auditors.

Japanese audit system has the following special features. (1) While the auditor has the legal authority to freely exercise his right to express the audit opinion he considers appropriate, his economic incentives attenuate the actual exercise of this right. Auditor's business affiliation with the client, and the interaction of audit opinion with other laws and regulations diminish auditor's bargaining power. (2) When a disagreement arises be-

tween the auditor and his client, both try to maintain their organizational relationship by internalizing the change (e. g., replacement of auditor in auditing firm). And even if we can understand non-legitimate (negative) and adverse (negative) opinion in Exhibit 4 is connected directly with delisting as a “sort of social sanction” (Toba [1993] p. 44), for the future, we have to make clear how Ministry of Finance (MOF) and securities exchange should deal with the overlapping range of CC non—legitimate (negative) opinion and SEL qualified (fair／affirmative) opinion.

## Glossary

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