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# Value for Money or No Value for Money?\*

## — A Case of Public Sector Auditing in Japanese Local Government —

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This paper examines issues that arise from the auditing practices of local governments in Japan. It deals specifically with a case of fraud involving the Hokkaido Prefectural Government, and relates this to the general problems that afflict the present public sector auditing in Japan. It seeks by these means to expose the relationship between auditing and public disclosure, and thereby explains why the auditing practices of Japanese local governments are unable to detect or prevent fraud.

**Keywords :** Local Government, Public Sector Audit, Disclosure.

### 1. Introduction

If you were to ask Japanese students for a definition of accounting, they might offer some such answer as "Accounting is the method by which the profits of a commercial enterprise are calculated." It is possible that a Japanese professional accountant might answer in a similar fashion. Such an answer, however, overlooks the existence of public sector accounting. We can suggest several reasons for this forgetfulness.

Firstly, the development of accounting and accountancy in Japan has a relatively short history, and during which time, the accounting profession has devoted its efforts to developing its expertise in the field of the public practice for private companies. It is well known that after the war, Japan learned a good deal from American accounting practice, coupled with the notion of competitive free trade. Japan's economic development has, in fact, taken place within the structure of a free trade competitive system. This entails that methods of corporate accounting have had to be developed, but it has not followed that similar methods have been developed in the public sector. Consequently, most of the Japanese basic accounting textbooks written for undergraduates have emphasized the importance of private sector accounting, even

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though many of those students will ultimately go on to work in the public sector.

Secondly, there could be a translation problem, that is, of nomenclature. In Japanese, the term used to render "accounting" is "kaikai" or "kaikai-gaku," while cost accounting is translated as "genka keisan," from "keisan," which means "calculation." National accounting is referred to as "kokumin keizai keisan," from "kokumin keizai," which means the national economy. Although, even in Japan, "genka keisan" is fortunately regarded as falling within the domain of accountancy, "kokumin keizai keisan" is treated as belonging to a completely different field of finance. Similarly, in the field of public administration, finance is called "zaisei," whereas in commercial enterprises it is called "zaimu" and in banking "kinyu." Recently, it has simply been called "fainansu," the Japanese rendering of "finance".

This confused situation has created a number of different areas of study, each with its own specialists, all of whom suppose themselves to be researching into absolutely separate matters. As a consequence, there is very little exchange of information or sharing of results in these fields. This has led to a lack of enthusiasm for research into Japanese methods of public sector accounting.

Thirdly, a surprising number of Japanese people consider that the public arena falls under the jurisdiction of public administration and its management is therefore the responsibility of administrators rather than accountants. Not surprisingly, therefore, Japanese students and research workers in accounting have had little incentive to study public sector accounting.

In a word, there is a general impression in Japan that public sector accounting is not of central importance in the world of accounting. Consequently, neither the people nor the accountants have shown much interest in public sector accounting, still less in public sector auditing.<sup>1</sup> There has therefore been far less argument over the typical auditing method for the public sector like the value for money auditing.

This negligence has generated serious problems in the practice of public sector accounting and auditing in Japan. In this paper, we shall therefore focus on Japanese local government and the problems that now face those local governments in the world of public sector accounting and auditing.

## **2. Fraud in Japanese Local Government**

It is desirable that we should begin with a brief explanation of the Japanese system of local government. Essentially, the Japanese system of local

1 On the Japanese accounting profession in the public sector, see Sakagami, Yoshimi and Okano (1999), pp. 348-351.

government is a copy of the system employed in the United States, and what in the US is called a State is, in Japan, known as a prefecture, although the term "prefecture" is a translation of a number of Japanese terms: "to", "do", "fu" or "ken."<sup>2</sup> There are prefectural assemblies, and a prefectural governor, all elected by the people. In addition, however, although most police officers count as prefectural officials, they are under the direct control of the central government. This means that although the prefectural government pays police salaries, the governor has no real control over their movements: the governor's apparent authority is purely formal.

Each prefecture consists of areas designated as cities, towns and villages. The residents elect mayors for each of these neighbourhoods, each of which also has its local assembly. For example, Hokkaido consists of 212 cities, towns and villages. It is thus easy to appreciate that Japan is composed of a vast number of local governments, and, in most districts, the local government is the biggest employer. In other words, since most of Japan's famous companies have their head offices in Tokyo or Osaka, regional local governments constitute the largest accounting entities in their respective districts.

After the Second World War, the Japanese re-modeled their local government system on the US system, under the influence of the Occupying Forces, who, strangely enough, did not establish an efficient auditing system at the same time. Thus only audit commissioners had audited Japanese local governments, and the Japanese Local Autonomy Law requires only four audit commissioners in the case of prefectures.<sup>3</sup> This means that the whole of the auditing process, even for such a huge body as the Tokyo Metropolitan Government, is left in the hands of only four people, who have to carry out the whole procedure. It is not required, however, that the audit commissioners must be drawn from such profession of Certified Public Accountants, while one of the audit commissioners must be a representative of the local assembly. Consequently, the audit commissioners may in practice have little knowledge of accounting.

Although the audit commissioners have their own offices and staffs, the numbers are small, and members may be transferred to other posts within the local government. We can therefore doubt whether the audit commissioner's office is likely to be either independent or impartial.

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2 There is one "to" (Tokyo-to), one "do" (Hokkaido), two "fu"s (Osaka-fu and Kyoto-fu), and forty-three "ken"s. Tokyo-to is sometimes referred to in English as the Tokyo Metropolitan Government.

3 In Japanese, these are referred to as "kansa-i-in", which, when officially translated into English, is rendered simply as "auditor". This can cause confusion since the term "auditor" is translated into Japanese as "kansa-nin," which means the person who audits in the most general sense. We shall therefore translate the Japanese "kansa-i-in" as "audit commissioner," which is the word's literal translation.

The US planners of the Japanese political structure also failed to make provisions for the public disclosure of information about the workings of local government. The law had not required local governments to publish information about their administration for a long time. The law in fact assumes that assembly will carry out inspection and correction. Although this may be appropriate in terms of the effective workings of the administration, it has meant, for many years, that it has been impossible for the public to acquire any accounting information of local governments directly.

Occasional scandals, such as the one in 1976 when the Lockheed bribery case came to light, have shown that even Prime Ministers may be guilty of criminal behavior. The public was shocked, and felt that a Law to enforce the disclosure of information was needed. Yet though the Diet began to debate the question, the growth of national prosperity caused the matter to be forgotten and it disappeared from the main political agenda. Fortunately, however, the issue was taken up at the level of local government.

In 1983, for example, Kanagawa Prefecture enacted a regulation regarding public access to accounting information. Many other local governments followed suit, although the contents of the regulations varied from prefecture to prefecture. This meant the manner in which information was disclosed and the levels of information to be disclosed also varied from local government to local government. Some local governments, at the request of the residents, disclose all the accounting information that they are asked to show. Other local governments, however, reject most requests for information, or if they do make documents public, they black out certain parts of the document.

At the end of 1995, the Hokkaido Prefectural Government was severely criticized for having spent large sums of money on entertaining officials of the central government. Since the climatic conditions of Hokkaido, which is principally an agricultural region, are in winter extremely severe, this means that it is a comparatively poor area, and it has always, as a result, had to rely on the support and munificence of the central government for financial support. This has in turn meant that it has got into the habit of entertaining officials of the central government out of its own (Hokkaido's) budget. The taxpayers have to fund the extravagant wining and dining in which officials of both the central and local governments indulge. Although such behavior is not illegal, the people of Hokkaido were extremely critical of this use of their money.

The taxpayers acquired this knowledge as a result of the regulations, instituted by the Hokkaido government, that require the disclosure of information. A number of them decided to establish an unofficial association of "civil ombudsmen," based on the formal system existing in Scandinavian countries, something quite unknown in Japan. On analyzing the accounting information

supplied by the Hokkaido governments, they found some interesting facts: for instance, some of the expenditure incurred on so-called business trips struck them as both dubious and unnatural.

In fact, they discovered that although the official documents had been completed, no such business trips had actually taken place, while the expenses for the trip had been paid to the claimant. The money was then spent on eating, drinking and having parties. Such bogus business trips are well-enough known about to have acquired a special name. The term "kara" means empty, and such fictitious expeditions are called empty business trips. Furthermore, other types of "kara" expenses including meetings, photocopy, dining and employment were detected. This money had accumulated in each section of the government, and of course had been off-balanced. For taxpayers of Hokkaido, these "kara" expenses obviously had no value for money.

Most of these "kara" expenses were found in the administrative sections of the government. Surprisingly, the same type of fraud was also detected in the office of audit commissioners. In other words, the audit commissioner himself was a party to the fraud. In one instance, six officers including the audit commissioner were recorded as having made a business trip to Akita to attend a meeting in October 1994. One of the six did not go on the trip, and in fact no meeting had actually been held. When suspicion of fraud surfaced, the office of the Hokkaido audit commissioners asked their opposite numbers in Akita to tell the media that the meeting had been held. It is apparent that to conceal the truth of their fraud from the public they were prepared to tell a lie.

By the end of February 1997, the sum total of expenses converted in this way amounted to around 4,050 million yen: this included around 7.5 million yen improperly used by the office of the audit commissioner.<sup>4</sup> The Hokkaido Prefectural Government claimed that parts of sum total were not "fraudulent" expenses but ones that had been "improperly recorded." Whatever term they like to use, however, it is clear that it was *not* proper for these expenses to be included in the financial report in such a misleading fashion. The audit commissioners had audited all previous financial reports, and their audit reports had stated that the financial reports were fair.

Such malpractices, however, have not been confined to Hokkaido. After the revelations of Hokkaido's dishonesty had been reported, groups of "civil ombudsmen" in other prefectures carried out similar investigations. In many other prefectures, comparable instances of fraud were uncovered, and in some of these prefectures the audit commissioners or members of their office had

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4 See Yoshimi (1997) and Yoshimi (1998).

engaged in similar fraudulent practices.<sup>5</sup> Even in prefectures where no fraudulent practices were brought to light, we cannot be sure that fraudulent activities had not occurred, since in many cases, such prefectures did not disclose sufficient documentation for the citizens groups to acquire the full picture, and thus acquire sufficient accounting information to establish fraud. In other words, it is not known for certain whether, in such prefectures, cases of fraud had occurred or not.

### 3. Was the Audit Needed?

Since the Japanese auditing system has not performed its proper role in the auditing of local government accounts, what was the point of auditing the accounts in the first place?

We can, at least, offer a number of explanations as to why malpractices went on for such a long time and remained undetected. In the first place, before the 1980s, little information was available about public sector accounting, and consequently the Japanese had little interest in it. Nor did professional research workers in the fields of accounting and auditing show much interest in it, either.

Secondly, the Japanese people feel that a tax is something to be collected but has nothing to do with them, and though we have used the term "taxpayer" in the previous section of this paper, the Japanese people are not familiar with such terminology. In such a situation, it is hard for people to have much interest in how taxes are spent by the government.

Thirdly, since most people were unaware of the existence of the audit commissioner system, they did not expect that the financial affairs of the local governments would be audited. That is to say, auditing had become a dead letter since nobody expected the audit commissioner to play his proper role since no one even knew of his existence. Indeed, most audit commissioners seem to have thought that their titles were purely honorary and may as a result have done nothing at all. Although they presented their reports to the assembly, such reports were meaningless, and were, in any case, never shown to the public.

How could such a situation have arisen, especially as the basic administrative system in Japan is the same as those found in Western countries? Although on the surface the systems may seem the same, the Japanese operate them differently because Japanese ways of thinking differ from Western styles of thought. In the West, the taxpayers watch the way that the tax is used.

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5 Similar instances came to light in Tokushima, Tokyo, Aomori, Akita, Miyagi, Mie, Kagoshima, Shimane, Fukuoka and Saitama Prefectures.

People are interested in value for money, and in many countries the auditors do carry out value for money auditing.

In addition, they elect representatives to the assemblies and the assemblies also watch how the administrative departments handle their finances. The voters assume that when they elect a member of the assembly to represent them, or when they pay taxes, they are entering into a contract with those they elect and those who collect their tax. They therefore watch their representatives carefully to ensure that the terms of the contract are adhered to. The administrative branch of the government has the responsibility of discharging its part of the contract, and must be prepared to be accountable for its dealings. It is therefore obliged to publish and make public many kinds of information about its management of affairs, and this will include information about its accounting practices.

In Japan, on the other hand, the voters who elect representatives, and pay tax, do not think of themselves as making a contract : they are reposing their trust in those representatives, and that trust is unlimited. To meet this expectation of trust, the governments at both national and local level take on unlimited responsibility for the residents of their localities. Both the public and the officials assume that a public officer has some special ability and expertise which is outside and beyond the competence of the ordinary citizen, and that he must carry out competently and completely tasks about which the residents have little or no knowledge. Even if the entrusted body (that is, the administration), were to make its achievements public, such an action would be meaningless because the general public would lack the knowledge to understand what it is that the government has done. There is therefore no need for any auditing, as, by analogy, no auditing is required when parents protect their children.

Yet if the person or body entrusted with such responsibility behaves dishonestly or neglects his responsibility, society will denounce such misconduct. The argument that governments should be held responsible for any wrongdoing is, in such situations, accepted by the public as proper, and valid.

All of this obviously rests upon the assumption that the members of the general public are weak and ignorant beings who must be protected. It would follow, should this be true, that even if information is made available to the public, the public might not have the competence to understand it. This would have been a reasonable assumption during the Meiji Era since the general public was illiterate and would have been unable to read any information that the government might choose to disclose through publication of its accounts.

Yet is Japan today a country where such an assumption would still be valid? The answer obviously is No. It is perfectly obvious when we consider

the instance of fraud in local governments. Local residents are now perfectly able to understand whatever information the governments decide to disclose. There is no longer any need for the voters to entrust everything to their governments without question and though the governments may not have total responsibility for what happens, they may be held accountable for whatever *does* happen. This would be our current expectation, but the Japanese administrative system is not suited to this kind of accountability. Once an information disclosure system had been established in local governments, this contradiction was exposed. It became particularly clear that the present method of auditing in Japanese local governments is a seriously problematic one.

#### 4. Conclusion

Here, we can establish or confirm a number of significant points. In the first place, disclosure of information can only be effective when both the supplier and the receiver of the information are able to understand its contents. This seems obvious, but when people assert the importance of the disclosure of information, they often forget that this will be futile if the information is not fully understood by those who receive it. We actually sometimes see the argument that the most important issue is the preparation of adequate information, and that it is less important whether or not it is presented in such a way that makes it suitable for general consumption. This seems quite wrong.

Secondly, auditing will only become truly significant when a proper information disclosure system comes fully into effect. The audit commissioner system, the only system operating in Japanese local government, was meaningless. Even after the information disclosure system had been established, the fact that the system was pointless was still not realized; indeed, the old, worthless system was reconfirmed. In the end, it has been the receivers and users of the information, the local residents, who have come to appreciate the importance of proper auditing.

The relationship between auditing and disclosure also seems obvious, but is, these days, also often ignored. Nowadays, as the range of accounting has expanded, so the area covered by research has become subdivided, with scholars specializing in their own limited fields, with the result that few of them take into consideration the relationship between accounting and auditing. Of course, it may be cogently argued that accounting and auditing are completely different disciplines, and we have still not been able to solve how best to relate them. One fruitful possibility for locating a fresh point of view might be the conducting of case studies such as the one we have carried out in this paper.

Thirdly, after these conditions have been laid down, the question of what we expect from an audit will arise. The reader/user of the accounting informa-

tion will notice the need for auditing after the disclosures have been made and the contents of the disclosures have been understood. This is what has happened in Japan : a local government authority made a public disclosure of its accounts and a local resident detected a fraud in the report. Before this occurred, local residents were hardly aware that an audit commissioner existed. Afterwards, however, they were able to understand the situation in a new light, and they wondered why the audit commissioners had not detected the fraud. They realized that the audit commissioner system was inefficient and perhaps fraudulent. Thereafter, they took it upon themselves to carry out the auditing of the local governments' accounting information. They also took out many lawsuits against the local governments to claim the return of the money that they argued had been used improperly.

When a discrepancy is discovered during auditing, it is common in the West to institute a lawsuit. In Japan, as is well known, it is most uncommon for citizens to initiate lawsuits against public bodies, so it is hard to appreciate that when a discrepancy in auditing has been uncovered, that the Japanese will bring a lawsuit against the guilty party.<sup>6</sup> The revelation that local governments can be guilty of fraud has shown that in cases of public fraud the Japanese public is now also willing to go to court.

Fourthly, auditing is meaningless if the auditor is not completely independent. Yet, as we have seen, the Japanese system lacked this elementary safeguard against malpractice. In the end, its inherent weaknesses exposed it, and the public became aware both of the existence of the office of the audit commissioner and of his wrong-doing.

After the series of malpractices of local government, an external audit examiner, who is known as the "external auditors," is introduced in addition to the present audit commissioner system.<sup>7</sup> Yet, from its inception, the new scheme will labor under the same disadvantages. The new external auditors will be drawn not only from the ranks of Certified Public Accountants, but also from bodies of Tax Accountants or the legal profession (none of whom can be expected to be entirely unbiased).<sup>8</sup> The reasons for this decision are political, since the phenomenon of accounting has now taken on a political cast. Yet, al-

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6 These conclusions are drawn from a comparative study of practices in Japan, Britain and Spain. See Yoshimi (1994), Humphrey, Moizer and Turley (1993), Garcia-Benau and Humphrey (1992), Garcia-Benau, Humphrey, Moizer and Turley (1993).

7 Not all audit commissioners believe that new auditors beside themselves are necessary. See Audit Commissioner Survey Commission of Nara Prefectural University of Commerce (1997), pp. 5-9.

8 The Japanese Institute of Certified Public Accountants (JICPA) set the first public sector accounting standards in 1997. See JICPA (1997). In 1991, before any of the local government's fraudulent activities had been brought to light, only 35 percent of the Japanese people thought that CPAs should audit the local government accounts. See JICPA (1991).

though the operation of the new commission will raise problems, the local residents will expect to see the new external auditors at work on their behalf.

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