

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Japan Makes Progress In Strengthening Public Confidence in Corporate Financial Reporting

by Kosuke Nakahira, Institute for International Economic Studies

The spate of corporate reporting failures witnessed in recent years in virtually all advanced economies has caused a serious loss of public confidence in financial reporting worldwide.

How to rebuild confidence has become a global issue, as evidenced at the close of the June G-8 Summit in Evian when the leaders issued a declaration, *Fostering Growth and Promoting a Responsible Market Economy*, which called for “restoring investor confidence through sound corporate governance, as well as corporate structures and market intermediaries that are more accountable.”

The private sector has also moved quickly. The International Federation of Accountants (IFAC) established a Credibility Task Force in October

2002 for the stated purpose of “rebuilding public confidence in financial reporting.” That task force (of which I was a member) produced a report the following August that outlined best practices recommended for all the participants in the reporting process of corporate financial information. It called for “extensive action – at both national and international levels to raise the credibility of financial reporting.”

Comprehensive Approach in US and Japan

Intensive efforts have been made to address this significant issue in almost all countries. Most notable was in the United States where the Enron and WorldCom scandals profoundly shocked corporate America. The resulting legislation, the Sarbanes-Oxley Act, which Congress overwhelmingly passed in July 2002, covered such broad areas as strengthened corporate governance, enhanced disclosures, more effective regulation of auditors, auditor independence and enhanced analyst responsibilities.

Japan also took a comprehensive approach. In addition to the amendments to the Commercial Code aimed at strengthening

corporate governance, Japan’s Financial Services Agency (FSA) announced a comprehensive program to proceed with securities market reforms in August 2002.

Japan undertook the following reforms:

Corporate Governance

Japan has reinforced its corporate governance system through amendments to its Commercial Code. The function of the board of corporate statutory auditors – which is by law independent of the board of directors – has been invigorated by providing that at least half the members must be independent. The definition of “independent” corporate statutory auditor has been tightened – any person who has worked for the company as a director or employee at any time in the past is no longer considered “independent.”

Effective April 2003, a new corporate governance system was introduced in Japan, namely the audit committee type structure. Listed companies in Japan now have two options for their corporate governance structure: they may have, as before, a board of corporate statutory auditors with

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strengthened independence. Alternatively, they can choose to have a board of directors with audit, nomination and compensation committees. In each committee, a majority of members must be independent. The freedom to choose between these two options is expected to foster competition between different governance systems under the common principle of strengthened independence from the management.

Disclosure Requirements

Disclosure requirements were strengthened, effective April 2003, in order to provide: (a) more detailed governance-related information such as internal control system, risk control system, directors compensation and audit fees; (b) more risk-related information such as dependence on specific counterparties and legal actions of material importance; and (c) more information on management's discussion and analysis (MD&A).

Auditor and Auditing

Major amendments have recently been made to the Certified Public Accountants (CPA) Law, to become effective April 2004. These reforms are intended to: (a) enhance auditor oversight; (b) strengthen auditor

independence; and (c) increase the number and improve the quality of the accountants. The amendments were based on the December 2002 recommendations of a Financial System Council subcommittee.

Auditor oversight will be enhanced by establishing an independent third-party board, the CPA and Auditing Oversight Board (CPAAOB), within the FSA. This Board will monitor the quality control review made by the self-regulatory organization, the Japanese Institute of Certified Public Accountants (JICPA). The CPAAOB will make an inspection of the CPAs and audit forms when necessary for public interests or investor protection and recommend the FSA necessary actions to be taken.

Auditor independence has received a particular emphasis. An explicit provision has been added to the law to clarify that CPAs have a mission and responsibility to conduct their services with independence, fairness and integrity for the protection of investors. Auditors are prohibited from providing certain non-audit services that are likely to pose significant threat to objectivity in their judgment and auditing. New regulations have also been introduced regarding rotation of engagement and review partners, as well as restrictions on the

employment of former engagement partners.

In order to meet the increased need for auditing, the CPA examination system has been modified with a view to attracting a greater number of qualified people such as financial experts. It is also intended to increase the total number of successful examinees.

Accounting and Auditing Standards

In the field of standards-setting, a private body, the Accounting Standards Board of Japan (ASBJ) was established in July 2001 and will play the central role of setting accounting standards in Japan. The Board is presently working on a new accounting standard for stock options.

New auditing standards were introduced, effective March 2003, on such matters as risk approach, internal control and going concerns.

Analysts

In January 2002, the Japan Securities Dealers Association, a self-regulatory organization, introduced new rules on the activities of securities analysts. In view of the recent incidents overseas, the enhanced rules were implemented, effective April 2003. Analysts are required to be institutionally independent from investment banking operations; their compensations

may not be linked to the performance of the investment banking business; and securities firms are required to disclose any conflicts of interest relating to the companies their analysts report on. Firms are required to establish review process in order to ensure the objectivity and integrity of research reports. These reports should not be disclosed to the companies until they are made public.

From Legal Framework to Action

As explained above, the framework of provisions, legal as well as self-regulatory, has well been put in place to restore public confidence. These provisions are not sufficient.

What is necessary, as the Credibility Task Force report puts it, is the “action – at all points along the information supply chain that delivers financial reporting to the market.” All participants in the supply chain are requested to build on the positive developments that have recently been attained.

Efficient capital markets are critical to achieve sustainable economic growth worldwide. Market forces have become significantly influential in Japan as well.

In the process of disseminating improved practices under the new legal and self-regulatory framework,

the market mechanism will play an increasingly prominent role.

Japan’s Steps — Indispensable Part of Global Efforts

The recent developments in Japan will constitute an essential part of the global efforts in this field. But it does not mean that all countries should have the same detailed rules.

While the process of globalization will undoubtedly continue, differences among countries will remain in management styles, corporate governance structures, relationship between the management and the labor, relationship between the management and other stakeholders such as creditors, suppliers and clients, because they are closely related to business culture and social tradition.

Our objective, therefore, is not to pursue one single system to be adopted by countries all over the world, but to seek to share the same principles under which each national system will function. Between those countries, it would be possible to apply a process of mutual recognition of each other’s systems.

The measures adopted in Japan are in line with the principles agreed upon in such international organizations and fora as the OECD, the

International Organization of Securities Commissions (IOSCO) and the Financial Stability Forum (FSF). There are much in common in substance between the provisions of the Sarbanes-Oxley Act and the comprehensive measures taken by a number of new legislations in Japan because they share the same principles.

But to what extent such developments are perceived outside Japan?

Need to Facilitate Understanding

Nearly half, and indeed, sometimes the majority of the Tokyo Stock Exchange’s daily turnover, is now undertaken by foreign investors. But most are institutional investors. Among ordinary individual investors, the recent steps taken in Japan to improve market infrastructure are not sufficiently recognized.

Language barriers may be one of the factors that stand in the way to apprehending the rapid changes such as new legislation, revised regulations, and reinforced self-regulatory rules one after another.

Intensified efforts will be required, through appropriate public relations activities on the part of Japanese market regulators, to facilitate better understanding of the most recent developments.

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Congress Rejects Proposed New “Buy America” Requirements for the Defense Department

by David W. Burgett, Hogan & Hartson LLP

After months of controversy, Congress has finally approved and sent President Bush the 2004 Defense Authorization Bill for his signature. But the original bill proposed by Duncan Hunter (R-California), Chairman of the House Armed Services Committee, contained several unprecedented and far-reaching restrictions on Defense Department (DoD) purchasing of foreign-made products and components.

These provisions were roundly attacked by major US defense contractors, who would have found the restrictions costly, and difficult or impossible to comply with. Key Senators, the Defense Department, the State Department, the U.S. Trade Representative (USTR) and others within the Administration who recognize the value of open trade for defense items, also objected, as did the EU, Japan, and other allies. After weeks of attempted compromise and intense lobbying, the final bill that emerged from the House-Senate conference committee eliminated most of the proposed restrictions and greatly reduced the impact of the remaining provisions.

While the immediate danger to defense trade has been largely

averted, it is likely that further “Buy America” proposals for the Defense Department and other agencies will be proposed and debated in the coming months. Some of the provisions that have been proposed – such as those relating to machine tools – could be of immediate importance to Japanese industry.

Principles Governing US Government Purchases of Foreign Products

In general, most US government procurements are open to products produced by most industrialized nations, including Japan. Some 62 nations, including the US and Japan, are signatories to the WTO’s Agreement on Government Procurement (AGP). Under the AGP, each member country gives equal treatment to products of the other countries when it purchases goods for public use. The AGP applies to any contract exceeding a monetary threshold (currently \$169,000) by almost all federal departments and agencies, as well as 37 of the 50 states. DoD is covered by the AGP for most commercial items, including computer equipment. But the AGP does not cover major military items, such as aircraft, tanks, naval vessels, weaponry, and the like.

The Department of Defense has entered Memoranda of Understanding (MOU) on reciprocal defense procurement with the defense ministries of the NATO countries and several other allies. These apply the equal treatment principle to defense items not covered by the AGP. Japan has no MOU because it is not generally engaged in defense trade due to the “three principles.”

The “Buy American Act” (BAA) gives a price evaluation preference for items produced in the US whose American components make up more than 50 percent of the total cost of components. For purposes of bid evaluation, a percentage increment is added to the price of goods that do not qualify for the preference (50 percent for DoD purchases and 6 percent for other agencies). But the BAA has very little significance today because it only applies in procurements that are neither covered by the AGP nor by defense MOUs. Defense items are covered by the MOUs and all important purchases of non-defense items exceed the AGP threshold of \$169,000.

The Hunter Bill

Congressman Hunter, the new chairman of the House Armed Services Committee, sought to

change the rules governing defense trade in the 2004 Defense Authorization bill. Hunter, convinced that the US defense industry is eroding and that steps should be taken to ensure that more US defense dollars flow to American business, inserted into the House bill several unprecedented restrictions on foreign items:

- A list of several specific items that could only be acquired from US manufacturers. These included some items that are explicitly covered by the AGP.
- A requirement for a detailed analysis of the value and country of origin of hundreds of thousands, if not millions, of components incorporated in defense equipment. Industry estimated that it would cost enormous sums to comply with this data-gathering exercise.
- A requirement that items and components deemed “essential” to a military system be produced in the US. This would entail massive cost and retooling, since there are numerous foreign components in most pieces of defense equipment.
- A rule that a trade agreement (such as the AGP) could not be a basis for waiving the Buy

American Act. This could have led to US violation of its obligations under the AGP.

- A requirement that defense contractors making major defense items use only US-made machine tools. Unlike typical “buy domestic” rules, this would extend beyond restricting the origin of goods that the *government* acquires, and dictate purchases of items that *private parties* acquire and retain for their own use.

The corresponding Defense Authorization bill passed by the Senate contained none of these provisions. So the stage was set for the differences between the two bills to be resolved by a House-Senate Conference Committee convened in July.

Controversy Over Buy American Provisions

Hunter’s Buy American provisions generated immediate controversy. Senator John Warner (R-Virginia), chairman of the Senate Armed Services Committee and leader of the Senate conferees, stated that he would not support any Buy American restrictions not acceptable to the Administration. Secretary of Defense Rumsfeld said he would recommend a Presidential veto if the Hunter provisions

remained in the bill. American industry associations and large defense contractors voiced strong opposition, pointing out that compliance would be extremely costly and that the cost and effectiveness of defense systems would be adversely affected. Moreover, major programs funded by multiple nations, such as the Joint Strike Fighter, would be jeopardized if the US embarked on a protectionist approach to defense procurement. The EU and other countries also expressed objections.

Deputy Secretary of Defense Paul Wolfowitz attempted to resolve the controversy by negotiating directly with Chairman Hunter to eliminate some provisions and reach compromises on others. This effort failed dramatically. While Wolfowitz reportedly struck an agreement with the chairman, he failed to consult Senator Warner, the White House, the State Department, or USTR. While the compromise significantly scaled back the original egregious provisions, it still contained many sections that would interfere with defense trade and hamper relations with trading partners.

At a White House meeting chaired by Chief of Staff Andrew Card, Secretary of State Powell and USTR Zoellick voiced objections.

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Following the meeting, the Administration position on the bill was coordinated by the Office of Management and the Budget. Finally, on November 5, the Conference Committee approved a final bill.

As finally passed, the Defense Authorization bill omits most of the restrictions on foreign items that Chairman Hunter had proposed. The relatively few remaining provisions will not make major changes in DoD purchasing practices. Under the final bill:

- No specific items are reserved for US industry.
- While the bill calls for the analysis of existing data on the number and value of “essential” components that are manufactured abroad, there is no requirement that any components be manufactured in the US.
- Trade agreements remain a valid basis for waiving the Buy American Act’s domestic preference.
- There is no requirement that defense contractors exclusively use US machine tools.

Importantly, the bill now explicitly stipulates that none of its provisions may violate an interna-

tional agreement, such as the WTO Agreement.

Machine Tool Provisions Could Yet Affect Japanese Industry

While the restriction on defense contractor purchases of foreign machine tools was dropped, three provisions remain that could have an impact on Japan and other machine-tool-producing countries. First, DoD is directed to make machine tools a priority for R&D funding. Second, a new government “industrial base” fund is established which could be used to subsidize defense contractors’ acquisition of US-made machine tools, to the detriment of foreign competitors. Potentially, such a subsidy might constitute a “state aid” in violation of the WTO Agreement. And third, when conducting major acquisition programs, DoD is for the first time directed to give “consideration” to a bidder’s use of US-made capital assets. It remains to be seen how this will be implemented, and whether it will have any significant impact on contract awards or on the defense industry’s purchases of machine tools.

Conclusion

Free traders can breathe a sigh of relief at the outcome reflected in the final bill. But the controversy over this bill is likely to be only the first

of a series of debates over the coming months and years over domestic restrictions in government procurement. Chairman Hunter believes fervently in restrictions on DoD purchases and will almost certainly try again. The reports on foreign component purchasing mandated by the legislation are designed to add fuel to the debate in coming years. Forthcoming congressional and presidential elections also focus public attention on issues such as this that are perceived to have an impact on employment.

In the short term, Japanese industry could be affected by any restrictions in the realm of machine tools. In the longer term, Japan may become more involved in producing componentry used in defense items. Finally, there is some reason for concern that “Buy American” fervor in the defense arena may adversely affect trading relations with Europe, Japan, and other major trading partners in other areas. ■

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Japan Business Dialogue

KKC's monthly program featuring Japanese experts on the economy.

Japanese Think Tanks Program

"Japanese think tanks and research institutes differ fundamentally from those in the United States in three ways," explained Akio Ema, Director for US and European Affairs at Mizuho Research Institute. Speaking at KKC's October 30 'Japan Business Dialogue' program, Mr. Ema said the differences lie in the philosophies underlying the establishment of the think tanks, in their financing, and in their functions.

American think tanks are typically established by visionaries with philosophical or political goals, Ema said. By contrast, very few Japanese think tanks have a policy-oriented mission. Instead, they are usually spin-offs of existing companies, banks, or government institutions and are profit-driven. Indeed, of Japan's 325 think tanks and research institutes, nearly 50 percent are for-profits.

Their financial support differs too. American think tanks are essentially funded by corporate, individual and foundation contributions. But in Japan, such giving is atypical – instead, the parent company or bank or government institution provides most funding by paying large commissions for conducting its research work. The

Japanese government represents a whopping 66 percent (57.5 billion yen in 2002) of all outsourced research activities.

Finally, their functions are different. American think tanks generally strive to contribute to the policy debate by offering fresh ideas and analysis. Research scholars, congressional staff and academics frequently work together to propose and shape policy recommendations, and then widely disseminate their findings.

But in Japan, there is little opportunity for research institutes to influence the political process, Ema explained. Typically, Japanese think tanks provide macroeconomic forecasting, and business-related analyses on a contractual basis; fully 85 percent of research is contracted by the firms that retain them.

contract research accounts for more than half of their work. Their product is seen only by their clients and does not enter the public domain. Much of the creativity and new ideas that spring from American think tanks is a direct result of the "revolving door" – a system in which high-level US government officials and businesspeople cycle in and out of public service and the private sector. The social structure in Japan is far more rigid, Ema contends, and there is a corresponding lack of freshness in the ideas and research put forth by Japanese think tanks. Over time, he said, Japan too will become more dynamic. ■

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Moreover, some 75 percent of Japanese think tanks polled by the National Institute for Research Advancement (NIRA) said that

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Securities dealers and other financial intermediaries are expected to cooperate. A deeper understanding of the investment climate will go far in improving investor confidence.

In recent months, the Japanese stock market has regained vigor, both in value and volume. We hope

this trend will continue. Strengthened public confidence in corporate financial reporting will be a key to the sustainability of a prosperous market. ■

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