Hitotsubashi University
Institute of Innovation Research

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Masaru Karube
Hironori Fukukawa

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Institute of Innovation Research
Hitotsubashi University
Tokyo, Japan
http://www.iir.hit-u.ac.jp

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Masaru KARUBE
Institute of Innovation Research,
Hitotsubashi University, Japan
karube@iir.hit-u.ac.jp

Hironori FUKUKAWA
Graduate School of Commerce and Management,
Hitotsubashi University, Japan
h.fukukawa@r.hit-u.ac.jp

ABSTRACT

To examine empirically the knowledge integration process of professional expertise that individuals have in a professional firm, this paper examines the emergence and growth of four large audit firms (ShinNihon, Azusa, Tohmatsu, and ChuoAoyama) in Japan over a period from the mid-1960s to 2010. Known as the Big Four, these firms—the product of a series of mergers between more than 70 audit firms—handled the vast majority of audit services for listed companies during this period. After the dissolution of ChuoAoyama in 2006, the remaining three audit firms have dominated the market.

A longitudinal case study documents how these professional service firms were successful in providing nationwide services through mergers with domestic competitors and the provision of global services in alliance with large international firms, even though they did not sufficiently realize the systematic attainment of individual expertise. The historical account of this process suggests that the two driving forces underpinning the merger growth of the Big Four were strategic intent in (1) systematizing individual expertise and (2) establishing nationwide and global service networks in response to the increase in size and growing diversity and complexity of their client base. Finally, this paper discusses the knowledge tension between localized individual expertise and organizational knowledge in a global context.

1. Introduction

With the ongoing rise of the "knowledge worker" (Drucker, 1959), the issue of how knowledge workers collaborate and create new knowledge through collaboration has become a more important research topic than ever. Because the competence of firms depends more on knowledge workers, we can well recognize their importance (Lorsch & Tierney, 2002). While scientists and engineers are typical examples of knowledge workers, our working definition should not be limited to these professions. Lawyers, accountants, and consultants are also knowledge workers, given their role as independent service providers (generally referred to as "professionals"), serving to support the development of capitalism (Starbuck, 1992). To examine the multifaceted issues of knowledge management in knowledge-intensive firms (Alvesson, 1995; Starbuck, 1992), we need to pay close attention to knowledge management in professional service firms—in particular, how professional knowledge workers collaborate between themselves and how collaboration is organized.

This paper addresses the development processes of audit firms, consisting of certified public accountants (CPAs) that have served as external auditors in the role of providing investors with the information necessary for equity investment. Our basic research question concerns why large audit firms through a series of mergers have replaced audit services, as initially provided by a single or limited number of individual accountants. To respond to this question, we examine the historical growth of Japanese audit firms during the period 1965 to 2010. We summarize the results of the historical case analysis as follows. First, as discussed in an earlier study on the growth of audit firms in the US (Wooton, Wolk, & Normand, 2003), the growth of Japanese audit firms has also been realized through recurring mergers between small, medium-sized and major audit firms. This has resulted in an audit services industry characterized by the dominance of a limited number of major audit firms.

Second, by examining the different levels of logic between individual professionals (CPAs) and small, medium-sized, and major audit firms, we clarify three different motivations for the expansion of the scale of operations and the systematization of audit services in Japan. These comprise the motives of independent CPAs and small audit firms: (1) to overcome the intrinsic contradiction between economic dependency and the independence of audit opinion, (2) to enhance their systematized audit capabilities to meet the growing and diverse need for audit services by client firms, and (3) to acquire new client firms by establishing a reputation for audit services.

Finally, the different levels of logic have promoted a progression of market entrances by de novo audit firms founded by independent CPAs and a succession of mergers between existing audit firms. This has led to the expansion of scale competition between independent CPAs and audit firms. These findings suggest that audit firms have succeeded in realizing the “scale expansion” of audit services in Japan, though it remains controversial as to whether the systematization of audit capability through the integration of existing knowledge has accompanied these developments.

2. Research background and Hypotheses

2.1. Characteristics of professional service firms

Professional service firms (PSFs) are a typical example of a “professional bureaucracy”. This is because the professionals in these firms work relatively independently of their colleagues, given the level of autonomy granted over their work, but closely with their clients, and they serve under a highly decentralized structure (Mintzberg, 1992). In contrast to goods-producing firms, we can identify four distinct characteristics of PSFs.

First, we can characterize the distinctiveness of these firms in terms of their outputs. Unlike the tangible nature of goods, the outputs of PSFs are intangible services whose quality is difficult to judge precisely (Starbuck, 1992). As a consequence, when clients select a certain service provider, they are obliged to rely on “social proofs of competence” of the provider, including reputation, social status and symbolic outputs, rather than any “substance of competence” (Greenwood, Li, Prakash, & Deephouse, 2005) in their decisions.

Second, we can also characterize the distinctiveness of these firms in terms of their inputs. Reflecting on one of the key characteristics of knowledge-intensive firms, PSFs depend on well-educated, highly qualified professionals such as lawyers in law firms, CPAs in audit firms, and consultants in consulting firms (Maister, 1993; Starbuck, 1992; Greenwood, Li, Prakash, & Deephouse, 2005). Such intellectual inputs are indispensable in generating distinctive service to clients because they are strategic assets rather than mere working forces (Lorsch & Tierney, 2002).

Third, in contrast to employees working at goods-producing firms, professionals work relatively independent of the firms to which they belong and have considerable control over both their own work and the decision to remain in the firm or to move to another firm (Alvesson, 2000; Lorsch & Tierney, 2002). Their general marketability may then weaken the organizational commitment of professionals to the firms to which they belong (Alvesson, 2000), resulting in tensions between the organizational goals of the firm and the individual goals of professionals. In turn, these tensions emerge from the three principal roles that professionals play as members of the firm: "[T]hey are *producers* who sell business and serve clients. They are *managers* in that they must help to run the firm. They are *owners* with a long-term interest in the firm" (Lorsch & Tierney, 2002: 21).

Finally, unlike simple, standardized, routine work, professional work depends more on the personal knowledge and skilled expertise of professionals as they provide their clients with customized services (Greenwood, Li, Prakash, & Deephouse, 2005). As this personal knowledge and expertise is tacit and esoteric in nature and deeply embedded in the professional–client relationship, the relationship is likely to be strong in that "… each needs the other and helps contribute to the health of the relationship"(Lorsch & Tierney, 2002: 20). Consequently, in order to realize the successful growth of PSFs, firms have to "… attract and retain the best people and motivate them to build enduring client relationship(s)" (Lorsch & Tierney, 2002: 24), at the same time as managing the organizational integration of two distinct personal relationships; namely, the relationship of professionals with their clients and the relationship of professionals with their firm.

2.2. Propositions and hypotheses

Based on these four distinctive characteristics of PSFs, the question remains as to how we can formulate the behavioral propositions for a single professional working independently, a single professional working for a firm, and a firm composed of partners, junior professionals, and staff. In addition, how can we propose hypotheses concerning the growth strategies individuals and firms are likely to pursue in these circumstances?

As suggested by the first characteristic, it is difficult for clients to measure the quality of service. Consequently, clients select a certain single professional or professional firm with reference to "social proofs" of competence rather than any direct knowledge of the "substance" of competence (Greenwood, Li, Prakash, & Deephouse, 2005). Social proof is "… a heuristic by which one makes a decision by using the actions of others to infer the value of a course of action" (Rao, Greve, & Davis, 2001). In the case of PSFs, clients may utilize this heuristic when they face uncertainty in judging which particular professionals or PSFs would be better in terms of the quality of service. In response to such behavior, both individual professionals and PSFs may pursue competition based on social proofs of competence, which is potentially affected by reputation, the status of others, and symbolic outputs (Greenwood, Li, Prakash, & Deephouse, 2005). Therefore, we derive the following proposition.

Proposition 1: Both individual professionals and PSFs are more concerned about gaining social proofs of competence rather than any substance of competence.

Reflecting on the dynamic nature of the relationship between the output and input of services, once an individual professional as an independent provider or PSF succeeds in establishing social proofs of competence, a virtuous circle emerges. That is, the more successful the individual or firm is in establishing a social proof of competence, the easier it is to attract and recruit professionals that are more talented. This leads to the additional establishment of the social proofs of competence. Conversely, once an individual professional or PSF fails in establishing the social proofs of competence, a vicious circle potentially emerges between the output and input.

Therefore, we can derive the following proposition.

Proposition 2: Whether independent service providers or PSFs grow depends on whether they are successful in creating a virtuous circle between output and input.

Moreover, as implied by the third characteristic, the possible tension between individual professionals and the firm suggests that firms need to integrate individual goals into a concerted organizational goal for the firm. In order to attract and retain the best professionals, this firm integration strategy should be attractive not only to existing members of the firm but also to other potential members, including those professionals that work independently or for other firms. Therefore, we derive the following proposition.

Proposition 3: Whether individuals and their firm are successful in creating a virtuous circle between output and input depends on how the firm integration strategy mitigates, balances and overcomes the tension between the individuals and the firm.

The fourth characteristic implies close relationships epitomized by mutual dependency between clients and service providers. As a resource dependence perspective suggests (Pfeffer & Salancik, 1978), clients depend on the knowledge, expertise, and reputation that providers possess, while service providers depend on client needs and economic resources. The dependency of clients on service providers makes it possible for providers to impose premium charges on clients by utilizing information asymmetry (Greenwood, Li, Prakash, & Deephouse, 2005). They can also utilize their client bases as strategic assets in that they utilize the names of existing clients to attract and acquire new clients. Conversely, the dependency of service providers on clients makes providers respond to their clients' needs, implying that service providers rely economically and technically on their clients. Consequently, the growth of service providers depends on the growth of their clients, such that the growth (contraction) of clients can promote (constrain) the growth of providers. Thus, while providers should continue to customize their services in response to the changing needs of their clients, they should also develop their client base by acquiring new clients. Therefore, we derive the following proposition.

Proposition 4: Service providers can exploit the dependency of clients for their assets while clients can make use of the dependency of service providers for their interests.

Combining these four propositions, we can identify the factors that drive the organization process of professional services that potentially leads to merger and acquisition (M&A)-based scale expansion by major audit firms and their market dominance in service provision. To start with, as the first proposition suggests, regardless of whether service providers are independent accountants or audit firms, we expect that they are more concerned about gaining social proofs of competence than the substance of competence. To do this, they pursue strategies that win reputation from clients, acquire good clients regarded as having high status, and produce symbolic outputs that are visibly appealing to clients. Reputation also derives from each client's own experience of audit services, or is inferred from the provider's past experiences, including their courses of action and results. Thus, past courses of action and experience for providers matter in gaining reputation from clients.

In the case of audit services, we can define "good clients" as financially healthier and larger organizations, and competitive organizations that assume a relatively dominant position in their industry. Having good clients serves to signal good audit service to other potential clients. Thus, the client's reputation itself matters for the establishment of provider reputation.

Audit services produce audit opinions for financial statements, but the quality and value of this service is not necessarily visible to outsiders. Moreover, in contrast to consulting services, as audit services derive more from the formal audit procedures decided by government, it is more difficult to differentiate services. Thus, the most symbolic output is the scale of services, as exemplified by the number of clients, the number of good clients, revenues from audit services, and the geographic coverage in providing services. In other words, scale matters as one of the symbolic outputs in audit services. Thus, we derive the first hypothesis.

Hypothesis 1: Auditors pursue an increase in the size of their client base as a symbolic output for gaining social proof of competence.

The competition for the scale expansion of client bases between single independent accountants and small, medium-sized, and large audit firms could favor larger firms because they are more competitive in establishing the social proof of competence. Thus, for a firm of any size, including single independent accountants, competition in scale expansion drives further scale expansion. Firms then realize the scale expansion of the client base in two directions: attracting and acquiring new clients, and integrating existing client bases. The integration of existing client bases is through the formation of new firms, either by gathering independent accountants or through M&A between audit firms. As new clients are concerned about the existing client base of audit firms, scale expansion through the integration of existing client bases also helps to attract and acquire new clients. Thus, we derive the second hypothesis.

Hypothesis 2: Competition for an increase in the size of the client base induces the integration of existing client bases through formation of new audit firms or by M&A between existing audit firms.

As Propositions 2 and 3 suggest, Hypothesis 2 will only hold if integration results in establishing further social proofs of competence. While competition could spur this scale expansion strategy, it could also result from the mutual dependency of clients and service providers. In the case of audit services, we focus on two factors related to the dependency of providers on clients. The first of these is the economic dependency intrinsic to the existing audit system: auditors should be independent of their clients as external auditors in producing audit opinion, while auditors depend on clients economically. This structural contradiction embedded in institutions as usual practice could become influential when auditors depend more on a small number of clients or on one large client. This contradiction could matter especially for independent accountants, small firms, or young de novo firms exemplified by the liability of newness (Freeman, Carroll, & Hannan, 1983). For that reason, an increase in the client base could strengthen economic independency on the one hand, and decrease the power of a given client on the other hand. We are also more likely to observe this behavior in independent accountants and smaller, younger firms, especially at an earlier stage of the industry life cycle, rather than in larger, more established firms.

Hypothesis 3: Economic dependence on clients induces independent accountants and smaller, younger audit firms to pursue scale expansion strategies at an earlier stage of the industry life cycle.

The second factor relates to the technical dependence of auditors on clients in the sense that auditors should technically realize audit services in response to their clients' customized needs. As clients ceaselessly improve and advance their existing business processes, or diversify business and geographic scope through internationalization, auditors should update their knowledge of their client's business and continue to systematize their organizational competence in response to the changing nature of client needs. An increase in client business size is an example in that the growth of client firms calls for the growth of their auditors so that they have ample human resources to provide a large-scale service, both nationally and internationally. An increase in the technical complexity of client businesses is another example in that auditors are required to upgrade their auditing competence to meet their clients' requirements. Therefore, it is possible to say that firms comprising a larger number of professionals provide better audit services. Moreover, as suggested by Propositions 2 and 3, it is easier for larger audit firms to attract talented people than it is for smaller firms because of the virtuous cycle between output and input. Combining these examinations, we derive the following hypothesis.

Hypothesis 4: The growth of clients, as epitomized by the increase in size and the technical complexity of client business, induces auditors to pursue scale expansion strategies through M&A.

In the next section, we introduce the historical case of the Japanese audit industry in order to examine the validity of the hypotheses proposed. As the methodology in this paper is exploratory and does not draw strictly on a hypothetico-deductive model, the proposed hypotheses are far from exhaustive. However, we believe that proposing hypotheses could yield some constructive guidance for our post hoc examination and interpretation of the historical case.

3. Current status of the Japanese Audit Industry

3.1. Rapid growth of the audit market and market dominance by major audit firms

Figure 1 plots the total number of audit firms that have entered the audit market for listed client firms, the total number of audit firms that have merged with each other and become a part of one of the four largest audit firms afterwards, and the total number of listed firms in Japan during the period from 1967 to 2012.[1] As shown, it is clear that market growth induces the entry of new audit firms, given that the numbers of listed firms and audit firms have continued to increase throughout the 45-year sample period. Figure 1 also shows that the number of audit firms that have become part of a major audit firm through M&A increased up until 1985 but has since decreased. This implies that many audit firms that later became a part of a major audit firm had entered the market by 1985, and the dominance of the major firms only became evident later. The three largest audit firms (ShinNihon, Tohmatsu, and Azsa)[2] dominate the share of auditing services for listed firms, although market growth has induced entry, such that there has been a steady increase in the overall number of firms providing auditing services for listed firms.

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Table 1 compares the number of listed client firms and market share by audit firm as at the end of March 1985 and at the end of March 2012. As at 31 March 1985, the largest audit firm was Chuo Audit Corporation, with 179 client firms and a market share of 9.91%. The second-largest was Asahi Audit Corporation, with 172 client firms and a market share of 9.52%. The third-largest audit firm was Tohmatsu Awoki Audit Corporation, with 120 client firms and a market share of 6.64%. The fourth- and fifth-largest audit firms were Showa Audit Corporation and Tetsuzo Ota Audit Corporation, with 114 and 106 client firms and market shares of 6.31% and 5.87%, respectively. The total share of the three largest audit firms amounted to 26.07% of the market for audit services, with the share of the five largest audit firms accounting for 38.25% of the market.

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However, by 31 March 2012, the situation had changed quite dramatically, with the largest audit firm now being ShinNihon, with 958 client firms and a market share of 26.7%, followed by Tohmatsu and Azsa (market share in brackets) with 905 (25.2%) and 685 (19.1%) client firms, respectively. The fourth-largest audit firm now was PricewaterhouseCoopers Aarata, with just 87 client firms and a market share of only 2.4%. Importantly, the three largest audit firms now accounted for 71.1% of the market, compared with 26.07% in 1985. This drastic change in market concentration during the period 1985 to 2012 suggests the oligopolization of the audit market for listed firms in Japan. This results from both the choices made by newly listed firms to source audit services from major audit firms and the acquiring of existing client firms through M&A by the major audit firms.

3.2. The three largest audit firms in Japan: ShinNihon, Tohmatsu, Azsa

As discussed, in 2012, the three largest audit firms, ShinNihon, Tohmatsu, and Azsa, dominate the audit market for listed client firms in Japan. As at June 2011, in terms of the number of listed client firms, ShinNihon is the largest audit firm engaged in audit certification work for 4,076 client firms and in nonaudit certification work for 2,837 client firms, with 5,822 staff members and total revenue of 95.9 billion yen. ShinNihon has 32 regional and three liaison offices in Japan, and 31 overseas offices as a member firm of Ernst & Young Global Limited.[3] The history of ShinNihon dates to three audit firms that had previously existed as independent firms. These are Tetsuzo Ota Audit Corporation, founded as the first audit corporation in Japan in May 1967 under the leadership of Tetsuzo Ota; Showa Audit Corporation, founded in December 1969; and Century Audit Corporation, founded in January 1986 through the merger of three independent audit corporations.

Tohmatsu is the second-largest audit firm and is engaged in audit certification work for 3,690 client firms and non-audit certification work for 2,921 client firms, with 5,959 staff members and total revenue of 81.6 billion yen. Tohmatsu has 29 regional and eight liaison offices in Japan as a member firm of Deloitte Touche Tohmatsu Limited.[4] Of particular note is that Tohmatsu is the only Japanese audit firm that is also one of the four largest international professional service networks in accountancy, often called the Big Four. The history of Tohmatsu dates to Tohmatsu Awoki Audit Corporation, founded in May 1968 under the leadership of one of the founders, Nobuo Tohmatsu, with a succession of mergers with small and medium-sized audit firms taking place since its foundation.

Azsa is the third-largest audit firm, engaged in audit certification work for 3,276 client firms and non-audit certification work for 1,923 client firms, with 5,744 staff members and total revenue of 88.0 billion yen. Azsa has 23 regional offices in Japan as a member firm of KPMG International.[5] The history of Azsa dates to three separate audit corporations: Asahi kaikeisha Audit Corporation, founded in July 1969 under the strong initiative of one of its founders, Shuji Ozawa; Shinwa Audit Corporation, founded in February 1974; and Inoue Saito Eiwa Audit Corporation, founded in September 1991 through the merger of Inoue Saito Audit Corporation and Eiwa Audit Corporation.

ChuoAoyama Audit Corporation, which changed its name to Misuzu Audit Corporation in September 2006, used to be one of the four largest audit firms in Japan until it decided to discontinue the operating entity in July 2007. The history of ChuoAoyama dates to the foundation of Chuo Audit Corporation (*Chuo Kaikei Jimusho*) in December 1968. Chuo Audit Corporation later merged with Shinko Audit Corporation in 1988 and changed its name to Chuo Shinko Audit Corporation. In April 2000, Chuo Shinko again merged, this time with Aoyama Audit Corporation, and changed its name to ChuoAoyama. The firm was later ordered by the Japanese Ministry of Finance to suspend audit services for two months in September 2006. This arose from the arrest of three of its accountants because of an incidence of accounting fraud in cooperation with a client firm (Kanebo) for the purpose of profit manipulation. While ChuoAoyama changed its name to Misuzu as an attempt to appeal to client firms as a new audit firm, the firm was obliged to dissolve itself following further revelations of multiple accounting frauds. The demise of Misuzu (ChuoAoyama) thus represents a Japanese analogue to that of the infamous Arthur Andersen in the US.

By focusing on the major merger cases, Figure 2 (ShinNihon), Figure 3 (Tohmatsu), Figure 4 (Azsa), and Figure 5 (ChuoAoyama/Misuzu) provide the genealogies of the merger processes taking place among Japanese audit firms during the period from 1967 to 2012. It is largely through these mergers that Japan's four largest audit firms have emerged. However, what specific processes drive the growth of scale expansion through M&A?

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4. Market Concentration through M&A between Audit Firms: 1965–2012

4.1. Frequent accounting frauds and the introduction of audit corporations: 1961–66

During the period from 1957, with the initiation of the first full-scope audit for listed firms in Japan, to the beginning of the 1970s, auditing had been mainly by single CPAs or jointly by a limited number of individual CPAs (see Tables 2 and 3, respectively). This dominant form of audit had the following potential problems. First, insufficient independent auditing was structurally embedded in institutional practice such that auditors should be independent of clients from a professional ethical perspective, even though they would depend on clients economically. Second, the client base was small, in that many single CPAs depended on a small number of clients for their livelihood, and this could impair independence because it was difficult for a sole practitioner to marshal the resources and expertise to audit large companies. Third, the audit industry was in its infancy, characterized by the fact that the social status of CPAs was neither high nor well understood, even among clients, reflecting the presence of generally young inexperienced CPAs in the early days of the industry. Finally, there was excessive continuity by a single auditor with a given client, which could also impair audit independence.

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A series of accounting fraud cases in the 1960s exposed these potential problems. At the end of March 1961, some 59 firms had engaged in accounting window dressing for 28 billion yen, with 138 firms and 79.5 billion yen involved at the end of March 1965. A number of accounting fraud cases led to criminal cases, with the suing of some accountants for malpractice.[6] Of the fraud cases, not only the top management of the client firms but also the accountants committed themselves to accounting window dressing with apparently little reluctance, with 48 accountants reprimanded and 78 accountants forced to make pledges to the Ministry of Finance.[7]

In response to the rapid increase in mistrust in the audit system and audit practices in Japan, the Ministry of Finance amended part of the Securities and Exchange Law in 1966 and decided to allow individual CPAs to establish audit corporations (known as *Kansa Hojin*) in order to encourage and facilitate the organization of individuals as corporations.[8] The expectation was that the adoption of audit corporations would promote and realize the systematic and standardized audit of financial statements and eradicate accounting fraud cases in which a single auditor depended heavily on a given client. This 1966 amendment also obliged individual CPAs to make decisions about whether they would keep their private accounting offices, as in the past, and sacrifice the chance to acquire listed firms as clients, or whether they would change their offices into newly formed audit corporations entitled to audit listed firms.

4.2. Foundation of de novo audit corporations through the gathering of individual accountants: 1967–73

The period after 1967, the year after the 1966 amendment of the Securities and Exchange Law had come into force, up until 1973 saw the foundation of 39 new audit corporations. Most of the accountants engaged in these foundations had faced limits in providing audit services under the form of their private offices, so they combined to establish audit corporations with the goal of realizing a systematic and standardized audit service. Key examples included Tetsuzo Ota Audit

Corporation, founded in January 1967 as the first audit corporation in Japan, Tohmatsu Awoki Audit Corporation, founded in May 1968, Chuo Audit Corporation, founded in December 1968, Asahi-kaikeisha Audit Corporation, founded in July 1969, and Showa Audit Corporation, founded in August 1970. All of these audit firms underpinned the development of the major audit firms that would later grow and combine into one of the five (later three) largest audit firms in Japan.

Tetsuzo Ota established Tetsuzo Ota Audit Corporation. He had been a well-known accounting professor and had also engaged in legislation of the Securities and Exchange Law and the CPA Act enacted in 1948 under the supervision of the general headquarters during the period of occupation by US forces after World War II. As he was a well-known figure in the field of accounting, many practitioners came to see him for his advice on their choice of external auditors.[9] Unlike many small private accounting offices that had difficulties in obtaining a sufficient number of listed client firms, Tetsuzo Ota Audit Corporation was exceptional in that it had an ample number of listed clients.

As suggested by its original name, Tohmatsu–Awoki–Tsuda–Tsukada–Awoki–Uno–Kasukabe Audit Corporation, seven private accounting offices in five cities (Tokyo, Nagoya, Kyoto, Osaka, and Fukuoka) founded Tohmatsu Awoki Audit Corporation in 1968 under the leadership of Nobuzo Tohmatsu. This was the first audit corporation in Japan intended to provide nationwide audit services. Since the time when he had qualified as a CPA in Japan and had become a partner in a foreign-affiliated accounting firm in 1952, Tohmatsu had felt the pressing need to improve the quality and social status of Japanese CPAs, and he believed strongly in the necessity of the systematic audit and internalization of audit services by Japanese audit firms. In those days, major foreign accounting firms (at that time, the Big Eight) accounted for the audit services of most overseas activities by Japanese listed firms.[10] In most cases when Japanese firms attempted to float loans in overseas markets, they had to accept audit services from the Big Eight, even if they already took audit services from Japanese audit firms for their domestic activities in Japan. This implied that the quality of audit services by Japanese audit firms was widely recognized as inferior or below the international level. Therefore, Tohmatsu’s ultimate goal was not only to establish a nationwide audit firm in Japan but also to make his firm internationally competitive with foreign audit firms.

The birth of the first nationwide audit corporation, Tohmatsu Awoki Audit Corporation, induced other independent CPAs to establish other nationwide audit corporations. One such example was Chuo Audit Corporation, founded seven months later under the initiative of three CPAs, Hiromichi Nakase, Tokugoro Murayama, and Thoichiro Toi, in cooperation with 20 private accounting offices that enjoyed strong client bases, including large listed firms. This strong foundation made Chuo the largest audit corporation.[11] Another example was Asahi-kaikeisha Audit Corporation, founded under the strong leadership of Shuji Ozawa, who had previously worked at Sumitomo Bank with 30 client firms, including firms affiliated with the Sumitomo Bank Group. Ozawa established Asahi in July 1969 with 24 CPAs who also had client firms affiliated with the Sumitomo Group.[12] The CPAs who echoed his vision were high-profile accountants in that they had several large client firms in the Sumitomo Group, including those who had worked with him before as former colleagues or clients, or had studied with him as classmates.[13]

Showa Audit Corporation, which later merged with Tetsuzo Ota Audit Corporation and changed its name to Showa Ota Audit Corporation in October 1985, was founded in December 1969, initially in order to compete against the nationwide audit corporations that had appeared during the period from 1968 to 1969. Establishing the firm with 24 accountants, the founder Kazuo Tomishima agreed on the need for large-scale audit corporations in order to realize systematic and standardized audits.[14]

4.3. Expansion of audit market and mergers among small and medium-sized audit corporations: 1973–85

Along with the Securities and Exchange Law applied to listed firms, the amendment of the Commercial Code in 1974 obliged firms with capitalization of a billion yen or more, and banks and insurance companies to undergo an external audit. Moreover, further amendment of the Commercial Law in 1981 expanded the scope of external audit to firms with capitalization of 500 million yen or more, and firms with total debt of 20 billion yen. This sequence of amendments represented an ideal opportunity for audit corporations to grow, inducing the entry of de novo audit corporations.[15] Competition between existing audit corporations and with new entrants drove mergers between small audit corporations and between small and medium-sized audit corporations.

The birth of Shinwa Audit Corporation is a prime example. Founded in December 1974, this was the result of the initiative of Taro Iguchi and Toshio Ohno and mergers between Daiwa Audit Corporation based in Osaka, and Ohtemachi Audit Corporation, Wako Audit Corporation, and some partners from Nihonbashi Audit Corporation, all in Tokyo.[16] Taro Ohno, one of the founders of Nihonbashi Audit Corporation, had agreed with Toshio Ohno of Wako Audit Corporation that scale expansion via merger between small audit corporations was indispensable to counteract the growth of the nationwide large audit corporations. The survival of Ohtemachi Audit Corporation, founded in January 1969 by six partners, was in doubt given an accounting fraud exposed in 1970 in one of its client firms. Daiwa Audit Corporation, founded by 16 partners in August 1969, had lost leading senior partners from window dressing accounting in 1970. The firm had also lost several major clients.[17]

The birth of Sanwa Tokyo Marunouchi Audit Corporation in April 1976 through the merger of Sanwa Audit Corporation and the Tokyo office of Marunouchi Audit Corporation was another example of a merger between small and medium-sized audit corporations. Sanwa Audit Corporation was a latecomer created by the integration of three private accounting offices previously engaged in the audit and other operations of Mitsui Corporation.[18] In turn, the Marunouchi Audit Corporation based in Nagoya spun off its Tokyo office in 1975, given conflicting perspectives on operation policy for regional offices. This merger plan was initially a plan for six different audit corporations that had no prior association with foreign accounting firms to acquire an international affiliation with foreign accounting firms. In hindsight, given comparison with the five largest audit corporations (Tohmatsu Awoki, Asahi, Chuo, Ota, and Showa), Sanwa Tokyo Marunouchi could not compete in size, and the merged firm was regarded as one of a number of second-tier audit corporations. However, Sanwa Tokyo Marunouchi has generally outperformed other firms in terms of acquiring newly listed client firms since the beginning of the 1980s.[19]

The birth of Shinko Audit Corporation in April 1978 from a merger between Fuso Audit Corporation, Chiyoda Audit Corporation, and Tsuji Audit Corporation was another example of an audit corporation intended to compete with the major audit corporations providing nationwide audit services.[20] Furthermore, in order to respond to the increasing enlargement and advancement of audit services spurred by the rapid growth of Japanese firms, many small private accounting offices had become too fragile to continue business, not only in terms of systematic audit competence but also in terms of attracting and recruiting talented professionals. This situation induced small audit corporations to merge with other small or medium-sized entities in order to pursue scale expansion growth.

In parallel with mergers between small and medium-sized audit corporations attempting to compete with major audit corporations, the competition for acquiring clients among major audit corporations drove them to pursue further scale expansion growth. For example, in January 1982, Showa Ota Audit Corporation, which had previously lagged behind other major competitors in acquiring new clients, announced a new policy comprising a scale expansion strategy, the provision of comprehensive services to improve services, the establishment of an international division, and an improvement in profitability to become the most competitive audit corporation in Japan. Showa Ota particularly emphasized the scale expansion strategy. “Regardless of whether they are private accounting offices or existing audit corporations, we have to put our concentrated and complete efforts into gaining new clients and urging private accounting offices or existing audit corporations to join our audit corporation. We need not only a system and culture to welcome professionals from outside, but also an incentive system under which existing partners are motivated to acquire new clients.”[21] On the other hand, Tohmatsu Awoki Audit Corporation continued to invite good and influential private accounting offices that had strong client bases to participate in its corporation. Jyunichi Aga Office in February 1975 and Thoru Takezaki Office in July 1976 are typical examples. For the most part, these offices were small private offices in terms of the number of professional staff members, but each had more than 10 listed firms as clients.[22]

4.4. Market concentration through successive mergers between major audit firms: 1985–1990

Created in July 1985, Asahi Shinwa Audit Corporation was the result of a merger between Asahi Audit Corporation, one of the major firms, and Shinwa Audit Corporation, a medium-sized audit firm at the time of the merger. Asahi Shinwa Audit Corporation overtook Chuo Audit Corporation in terms of number of staff members, and the merged firm became the largest audit corporation, with 1,048 client firms, including 302 firms to which the Securities and Exchange Law or the Commercial Code applied.[23] The merger opened a new era of impending mergers between large major audit corporations. The births of Showa Ota Audit Corporation in October 1985, Century Audit Corporation in January 1986, and Tohmatsu Awoki & Sanwa Audit Corporation in October 1986 were all examples of mergers involving large major firms. The birth of Chuo Shinko Audit Corporation in July 1988 through the merger of Chuo and Shinko was the last merger between major audit firms in the 1980s. Because of these mergers between major audit firms, a new market structure, characterized by the market domination of the five largest audit corporations, emerged. These initially comprised Asahi Shinwa, Chuo Shinko, Tohmatsu Awoki & Sanwa, Showa Ota, and Century, later reducing to four and then three audit firms in the 1990s and 2000s with further mergers.

This succession of mergers reflected the competition for scale expansion among major audit firms. What drove this competition in the mid-1980s was their rivalry in becoming a designated auditor for three newly privatized public corporations; namely, the Nippon Telegraph and Telephone Public Corporation, Japan National Railways, and the Japan Tobacco & Salt Public

Corporation. As these firms were all large, the expectation was that the designated auditor or auditors would have sufficient human resources to provide audit services for such large firms. Moreover, many audit corporations shared the understanding that audit service was in essence difficult to differentiate, so that the size of the audit firm mattered for gaining these sorts of clients.[24]

The plan for merging Asahi with Shinwa motivated their intention to increase their size in order to become an auditor for these large public corporations. Inside Tohmatsu Awoki Audit Corporation, its managing committee made the decision to promote mergers with other audit corporations in January 1985 by exploring opportunities with other large audit corporations and loosely coupled cooperative agreements with small private offices. Even at the party held in July 1985 to celebrate the birth of Asahi Shinwa Audit Corporation, the partners of Asahi Shinwa discussed with the partners of Tohmatsu Awoki Audit Corporation whether Asahi Shinwa would merge with Tohmatsu Awoki Audit Corporation, and later Sanwa Audit Corporation would join the merged corporation.[25]

Eventually, the largest and second-largest audit corporations (Asahi Shinwa Audit Corporation and Chuo Audit Corporation, respectively) were selected as auditors for the Nippon Telegraph and Telephone Corporation. The third-largest audit corporation (Tohmatsu Awoki) was selected as auditor for Japan Tobacco Inc. The fourth- and fifth-largest audit corporations (Tetsuzo Ota Audit Corporation and Showa Audit Corporation, respectively) lagged behind the other major audit corporations in the competition to become auditors for large public corporations. The remaining opportunity was to become an auditor for the Japan Railway Company, so for Tetsuzo Ota Audit Corporation and Showa Audit Corporation, the opportunity was a matter of life or death. Moreover, as Tetsuzo Ota Audit Corporation was nearly twice the size of Showa Audit Corporation, both expected that a merger would double their size in a single stroke, altering their market position drastically and prompting them to merge.[26]

The birth of the largest audit corporation, Asahi Shinwa Audit Corporation, induced a wave of mergers between second-tier audit corporations that had grown independently. Moreover, second-tier corporations had to respond proactively to the change in client needs because they were required to respond to increasingly intricate audit services required by the advancement and internalization of their clients' businesses on the one hand and the need to invest in computerized audit systems on the other hand. The fact that the investment required for computerized audit systems was too great largely promoted mergers between these second-tier firms.

For example, the birth of Century Audit Corporation, the result of a merger between Daiichi Audit Corporation, Nisshin Audit Corporation, and Musashi Audit Corporation in January 1986, is a prime case. Daiichi Audit Corporation initially began operations in March 1969, and as its name suggested, had client firms affiliated with Daiichi Kangyo Bank Group.[27] Nisshin Audit Corporation, founded in Osaka in November 1970, had prestigious clients such as Matsushita Electric Industrial Company (later, Panasonic). Although Musashi Audit Corporation, founded in September 1971, had been successful in acquiring and retaining prestigious "good" clients such as Hitachi, it had only 31 accountants. Accordingly, its scale of operation was not sufficient to provide system audits or to extend services to consulting and international tax services. As these second-tier firms had large prestigious client firms, they did not have to pursue the scale expansion strategies pursued by the large major audit firms. However, in addition to competing with major firms, they had to enlarge their business, not only in terms of gaining clients but also in terms of recruiting talented professionals when they attempted to respond to the increasing advancement, complexity, and internationalization of their clients' businesses.[28]

Mergers between the large major audit corporations induced yet further mergers. It was the merger between Chuo Audit Corporation and Shinko Audit Corporation in 1988 that resulted in the birth of Chuo Shinko Audit Corporation. As one outcome, the previously largest audit corporation, Chuo, slipped to second place. Moreover, because of the birth of Showa Ota Audit Corporation in October 1985, Chuo again slipped to third place in the market. This was also the case with Shinko Audit Corporation. Shinko was the sixth-largest corporation, but it lagged far behind the largest. As a merger would make it possible to become the largest audit corporation again, Chuo and Shinko were motivated to create a new audit corporation through a merger.[29]

4.5. Mergers spurred by reorganization of foreign firms and clients: 1990–2000

Large major audit firms that had intended to gain large and good clients led the wave of mergers and spurred the competition for scale expansion during the period from 1985 to 1988. In contrast, the mergers during the period from 1990 to 2000 resulted from the reorganization of foreign accounting firms or the reorganization of client firms. The first example of the former is the birth of Tohmatsu Audit Corporation through the merger of Tohmatsu Awoki & Sanwa Audit Corporation and Mita Audit Corporation in February 1990. The second example is the birth of Asahi Audit Corporation through the merger of Asahi Shinwa Audit Corporation and Inoue Saito Eiwa Audit Corporation in October 1993. The third example is the birth of ChuoAoyama Audit

Corporation through the merger of Chuo Audit Corporation with the sixth-largest Aoyama Audit Corporation in April 2000.

The momentum for the merger between Tohmatsu Awoki & Sanwa Audit Corporation and Mita Audit Corporation dated from the reorganization of the foreign accounting firms with which Tohmatsu Awoki & Sanwa and Mita were respectively affiliated: the merger of Deloitte Haskins & Sells International and Touche Ross International. This prompted the merger between Tohmatsu Awoki & Sanwa Audit Corporation and Mita Audit Corporation because Deloitte Haskins & Sells International engaged in the audit services for international activities by Mitsui Corporation and Mitsubishi Corporation, while these companies were also clients of Tohmatsu Awoki & Sanwa for their national activities.[30] Deloitte Haskins & Sells International founded Mita Audit Corporation in July 1985.[31]

The merger between Asahi Shinwa and Inoue Saito Eiwa in October 1993 is another example. The international merger between Arthur Young and Ernst & Whinney in 1989 led the national merger. As Asahi Shinwa used to be a member firm of Arthur Young, and Showa Ota used to be a member firm of Ernst & Whinney, the international merger in 1989 brought forth two member firms of Ernst & Young in Japan. Based on the principle of an international network of accounting firms, only one audit firm could represent each country. Therefore, Asahi Shinwa and Showa Ota each either had to find a new international network or had to merge. Although they sounded out the Japanese Ministry of Finance on the merger, it declined. After all, it was Asahi Shinwa's decision to participate in the Arthur Andersen network.[32]

Furthermore, Asahi Shinwa's participation in the Arthur Andersen network naturally led to the merger with Inoue Saito Eiwa Audit Corporation, as it was also a member firm of the Arthur Andersen network in Japan. Inoue Saito Eiwa Audit Corporation was founded in September 1991 through the merger between Tatsuo Inoue Accounting Office, which was founded by Tatsuo Inoue in April 1978, Chuo Kyodo Audit Corporation, which was founded by Rikio Saito in May 1974, and Eiwa Audit Corporation, which was founded by Arthur Andersen as its office in Japan. As a result, Inoue Saito Audit Corporation had a more than 20-year operational relationship with Eiwa Audit Corporation. The fact that many of their accountants used to study together as classmates at the same university worked for each firm in promoting the merger.[33] The birth of ChuoAoyama Audit Corporation in April 2000 was another example of a merger driven by that of the international accounting firms with which Chuo and Aoyama respectively were affiliated; namely, the merger of Price Waterhouse and Coopers & Lybrand in July 1998. Chuo used to be a member firm of Coopers & Lybrand network in Japan while Price Waterhouse founded the Aoyama Audit Corporation in June 1983 as its Japan office.[34]

In contrast to the series of mergers between national audit firms in Japan driven by those between the Big Eight, the merger between Showa Ota Audit Corporation and Century Audit Corporation in April 2000 was an example of a merger promoted by the merger of client firms.[35] Although Showa Ota ranked fourth in terms of market share and Century ranked fifth, both lagged far behind their three largest competitors in terms of revenue and the number of clients. In order to overcome this situation, they had to merge for the sake of scale expansion, not only in terms of potentially acquiring new clients but also in terms of recruiting new professionals.[36] The direct momentum was the merger between Fuji Bank and Daiichi Kangyo Bank. Fuji was the client of Showa Ota Audit Corporation, while Daiichi Bank was the client of Century Audit Corporation. The birth of the giant bank (Mizuho Bank) obliged the two audit corporations to merge in order to respond to the increased size and complication of their client's business.[37] Through this merger, the Century Ota Showa Audit Corporation became the largest audit firm in Japan, with 2,610 staff members and 4,881 client firms with 34.4 billion yen of revenue.[38]

4.6. Mergers of regional and major audit firms

Fierce competition for scale expansion among the major audit firms promoted not only mergers with other major audit firms but also mergers between major audit firms and small regional audit firms. The major audit firms pursued this strategy for the purpose of providing a nationwide service and gaining regional clients in good standing, whereas the small regional audit firms were induced to merge with major firms in order to overcome economic vulnerability and to respond to changing and increasingly complicated client needs. Regional audit firms also faced the difficulty of recruiting a sufficient number of new professionals to respond to these needs.

The case of Tetsuzo Ota Audit Corporation is the oldest. In competition with Tohmatsu Awoki Audit Corporation, which had realized the first nationwide service in 1968, Tetsuzo Ota urged individual accountants in regional cities to join the firm. Finally, 11 accountants from regional cities participated in the firm, and each private office became a regional branch office of its nationwide service. Economic vulnerability motivated individual accountants in regional cities to join major firms, while major firms were motivated to merge with regional offices owned by individual accountants to provide nationwide service.[39]

Chuo Audit Corporation also attracted individual accountants in regional cities to join the firm. Since the 11 accountants from Uto Audit Corporation joined the firm in 1981, Chuo had merged with Chunichi Audit Corporation in Nagoya and Shinsei Audit Corporation in Kobe in July 1986 and with Uniee Audit Corporation in Nagoya in April 1988. The difficulty that these regional audit firms experienced in recruiting accountants that could respond to the internalization of client business induced them to merge with major firms.[40] The merger of ChuoAoyama Audit Corporation with Itoh Audit Corporation in January 2001 was another example. ChuoAoyama was interested in a merger in order to enhance its client base because Itoh enjoyed a strong client base in Nagoya, including Toyota Motor Company. After the merger, the regional audit firms became regional branches of the merged firms.

The merger between Asahi-kaikeisha Audit Corporation and Ishimitsu Audit Corporation was another illustrative example. Considered a competent audit firm, Ishimitsu, founded in October 1971 in Hiroshima, had difficultly recruiting professionals that could respond to the growing and diversifying needs of its clients. Since then, Asahi-kaikeisha had continued to establish regional branch offices until the mid-1980s.[41] These regional offices were established through the participation of individual professionals with good clients in regional cities. Even after the merger of Asahi-kaikeisha with Shinwa, Asahi Shinwa continued to promote mergers with small audit firms in regional cities. Following the merger with Arthur Young's Tokyo office in June 1986 (as the starting point for the evolution of Asahi Shinwa), the firm subsequently merged with five small audit firms in regional cities with which it had business ties as Asahi-kaikeisha. These included the merger with Fukuoka Center Audit Corporation in Fukuoka in July 1986, the merger with Yokohama Kannai Audit Corporation in Yokohama, the merger with Sapporo Chuo Audit Corporation in Sapporo, the merger with Nagoya Daiichi Audit Corporation in Nagoya in October 1989, and the merger with Kayo Audit Corporation in Gifu in April 1991.

For the most part, these regional audit firms could not adequately respond to their clients' needs and experienced difficulties in recruiting new professionals able to engage in internationalized and advanced audit services. Moreover, in competition with the major audit firms in the regional cities, it became more difficult for small regional audit firms to retain existing clients and to develop new clients.[42] The mergers of Tohmatsu Awoki & Sanwa Audit Corporation with Marunouchi Audit Corporation in April 1988, and Sapporo Daiichi Audit Corporation in Sapporo with Nishikata Audit Corporation in October 1988 reflected the intention of the major audit firms to provide a nationwide service. It also indicated their wish to acquire good clients from small audit firms on the one hand, and the intention of the small audit firms to enhance their audit systems on the other hand. For instance, Sapporo Daiichi had been troubled with the development of new clients because of its location in a regional city.[43] Nishikata faced difficulty in retaining existing professionals because many senior partners left the firm in order to succeed to other accounting offices owned by their relatives or to start their own firms.[44]

Elsewhere, Marunouchi, Sapporo Daiichi, and Nishikata faced common management issues in response to the growing needs of their clients: difficulties in recruiting and retaining competent professionals, further enrichment of education programs for professionals, support for internalization and computerization in providing audit services, and the development of new client bases.[45] Furthermore, in addition to accounting and audit services, clients wanted more systemic support for their information systems and consulting services, and it became increasingly difficult for the smaller audit firms to respond to these expectations.[46] Accordingly, these three audit firms searched for counterparts with which to merge.[47] Conversely, mergers with these firms were attractive for Tohmatsu Awoki & Sanwa because the merger with Marunouchi would provide a base in Nagoya, while the merger with Sapporo Daiichi obtained a base in Sapporo. Nagoya was the largest city in the Chubu region of Japan, and Sapporo was the largest city on the northern Japanese island of Hokkaido. The strong client base of Nishikata Audit Corporation included some large listed firms affiliated with Mitsubishi Group, and this attracted Tohmatsu Awoki & Sanwa to merge with Nishikata.

Century Audit Corporation, which was one of the major firms, was also motivated to merge with audit firms with good clients in regional cities in order to compete with other major firms for scale expansion. For example, Century merged with Eiko Audit Corporation based in Sapporo in April 1987 in order to absorb its strong client base, including large listed firms such as Hokkaido Takushoku Bank, Snow Brand Milk Product Co., All Nippon Airlines, Mitsubishi Estate, and Nippon Express.[48] The merger with Yoko Audit Corporation in July 1992 reflected Century's intention to absorb another strong client base comprising Ezaki-Grico, NTN, and Daihatsu. While Yoko used to be a renowned firm, it had difficulty in providing the information and advice required by its client firms that had grown internationally.[49]

4.7. The demise of Misuzu Audit Corporation and the birth of the three largest audit firms: 2006–2012

The Financial Service Agency of Japan suspended ChuoAoyama Audit Corporation from providing some statutory auditing services in May 2006 for two months because one of its clients (Kanebo) announced an accounting fraud in April 2005. Kanebo subsequently was delisted two months later in June 2006, and this was followed by the arrest of three partners of ChuoAoyama in September 2005 for assisting with accounting fraud in boosting earnings over the course of five years. After the two-month suspension, ChuoAoyama changed its name to Misuzu Audit Corporation in order to resume operations in September 2006. However, another case of accounting fraud was revealed, and Misuzu was dissolved at the end of July 2007.[50]

The sudden demise of Misuzu Audit Corporation signified the end of a major audit firm, which dated back to the Chuo Audit firm founded in 1968. It also involved the disappearance of a workplace for professionals, the disappearance of a business partner for client firms, and the disappearance of an international partner in Japan for Price Waterhouse Coopers. Nevertheless, the demise of Misuzu also presented an attractive opportunity for the remaining audit firms to acquire talented accountants and good clients from Misuzu. In order to stem any possible client attrition and the drain of CPAs from ChuoAoyama, Price Waterhouse Coopers helped the former partners of Aoyama Audit Corporation to set up a new audit firm named Arata Audit Corporation in June 2007. Most of the clients of Aoyama Audit Corporation then succeeded to Arata. Some other partners founded a different audit firm named Kyoto Audit Corporation in July 2007 for client firms based in Kyoto. The remaining client firms changed their audit firms to the other three major firms (ShinNihon, Tohmatsu, and Azsa).

4.8. Scale expansion through merger and internal integration

As discussed so far, it was true that a succession of mergers realized the scale expansion of major audit firms and their market dominance. However, did scale expansion through mergers contribute to an improvement in organizational competence in providing better-qualified audit services that could eradicate accounting fraud? Examining the merger process of large accounting firms in Canada, Greenwood, Hinings & Brown (1994) pointed out that “strategic fit” would matter in the negotiation process, while “organizational fit” would matter in the merger integration process. In the case of the mergers between audit firms in Japan, each firm considered the strategic complementarities between firms before the merger. They then faced any unintended integration issues relating to the management of the merged firm, including difficulties in integrating different organizational cultures, the integration of audit practices, and the rotation of professionals between divisions that could promote the transfer of knowledge and experience.

The merger of Tetsuzo Ota Audit Corporation with Showa Audit Corporation in October 1985 provides a good example of the difficulty in integrating different organizational cultures between two audit firms. Although both senior partners optimistically expected that as each firm had almost the same size and similar organizational cultures, integration of the merged entities would be easy, it took longer than initially expected as they had very different organizational cultures. In particular, Tetsuzo Ota Audit Corporation operated under the strong leadership of its charismatic founder, Tetsuzo Ota, while Showa Audit Corporation operated in a more decentralized manner, reflecting its development as a firm founded through mergers between multiple private offices.[51] In fact, it took some two years and eight months to integrate the internal rules and audit practices in the merged firm, and the former names and terminologies continued in use even after the merger in order to distinguish the members of "former Ota" from the members of "former Showa".[52]

Such difficulties were especially likely in audit firms created through the merger of many small private accounting offices in the early stages of the industry. The cases of Shinwa Audit Corporation, Showa Audit Corporation, and Asahi-kaikeisha were examples in which newly created firms had to integrate different organizational cultures, practices, mindsets, and organizational goals. For example, the fact that the name of the audit office in many audit firms preserved the names of the original founders, even after the merger integration process, is a good indication of the inadequate integration of the client bases. Likewise, the lack of personnel rotations driven by a strong relationship between clients and a given accountant were often brought into the new audit firm, with clients designated as being "untouchable" for other partners.[53] It is true that the basis for professional service should be mutual trust between clients and accountants, so that the firm should not just operate in some decentralized manner as a mere collection of independent private offices for some time, even after the merger. However, in the light of the substantial integration of organizational competence, there should be efforts to remove such weak integration as soon as possible after the merger. In the case of Asahi-kaikeisha Audit Corporation, it took nearly 10 years to dissolve the personalized audit system and to systematize the job and client rotations of junior professionals among audit offices within the firm.[54] As a result, Japanese audit firms succeeded in gaining social proofs of competence by way of scale expansion through mergers rather than realizing the substance of competence, in that they still faced difficulties with the internal integration of the merged firms.

5. Discussion and Conclusion

5.1. Three different logics for scale expansion growth through mergers

As shown in Figure 6, the proportion of audit services provided by audit firms continued to increase, while that of audit services provided by individual accountants continued to decline. Based on the case analysis discussed in this paper, we found three different motives for promoting scale expansion growth through merger, all concerning the motives of independent CPAs and audit firms. These are: (1) efforts to overcome the contradiction between economic dependency and the independence of audit opinion, especially in small audit firms, (2) efforts to enhance systematized audit capability to meet the growing and varied needs for audit services by client firms, and (3) efforts to acquire new client firms by establishing a reputation for their audit services.

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Insert Figure 6 about here

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We can attribute the first rationale for scale expansion through merger to the “structural contradiction” embedded in institutional practice under which external auditors should be independent at the same time as they depend on their clients economically. Especially in the early stage of the industry, social status for CPAs was not high, with most dependent on a limited number of clients. The only way to overcome such contradiction and economic vulnerability was to increase the size of the business to strengthen the client base, because an increase in size was the only way to reduce the effect of the voice of a given client. As Hypothesis 3 suggests, the first rationale could apply to individual professionals or small audit firms in the early stage of the industry life cycle.

As Hypothesis 4 suggests, we can attribute the second rationale for scale expansion through merger to the rapid growth of the client firms. In our case, Japanese listed firms grew rapidly from the 1960s to the 1980s. Accompanied by this growth of their client firms, audit firms had to enhance their systematized audit capabilities in response to the growing and diverse needs for audit services. Scale expansion through mergers became the only way for individual professionals and audit firms to respond to these client needs. In other words, client growth promoted scale expansion strategies among service providers.

As Hypothesis 1 and Hypothesis 2 suggest, we can attribute the third rationale to the competition for social proof of competence among audit firms. We can divide such competition into (1) competition between major firms and small and medium-sized audit firms, and (2) competition among major firms. Competition of major firms with small and medium-sized audit firms became fiercer when major firms attempted to extend their services at the nationwide level at the same time as client firms initially based in regional cities attempted to extend their businesses nationally and/or internationally. As a result, small, regional audit firms lagged behind major firms, not only in recruiting and retaining professionals but also in attracting, retaining, and developing clients. Explicit differences between major audit firms and small audit firms in terms of the substance of competence then drove the merger of major firms with small firms in regional cities.

However, such explicit differences did not exist between major firms in terms of the substance of competence. Rather, it seems that no explicit difference in terms of the substance of competence promoted further competition for scale expansion. In other words, scale itself came to serve as a symbol of competence in the competition process between audit firms, especially large major firms. Scale expansion through merger then emerged as a reflection of the intense competition for the social proof of competence.

5.2. Consequences of scale expansion growth through mergers

The original idea underlying the introduction of the audit corporation in 1966 was to systematize and standardize audit services initially provided by individual independent CPAs for the purpose of providing better-qualified information to investors and eradicating accounting fraud. In this light, we should examine whether Japanese audit firms that realized scale expansion growth through merger could succeed in improving organizational audit competence. Otherwise, organizational competence could be just the mere collection or aggregation of personal audit competencies.

While we did not empirically examine in this paper whether Japanese audit firms succeeded in building organizational competence attributable to personal competence, some anecdotes suggest such a possibility. For example, the pattern of mobility of accountants accompanied by the demise of Misuzu Audit Corporation indicates the insufficient integration of the merged firm. Likewise, some former partners and accountants of Aoyama Audit Corporation set up a new audit firm named

Arata with the support of an international partner and their clients. Other partners and junior accountants moved together as an audit team or as a regional office to other audit corporations. At the time of the merger between Chuo Audit Corporation and Aoyama Audit Corporation, it was argued that the merger could be a combination of very different organizational cultures: a combination of a typically Japanese organizational culture in Chuo and a typical Western-style organizational culture in Aoyama (given that it was originally founded as the Tokyo office of Price Waterhouse).[55] The fact that this mobility was observed six years later when Chuo and Aoyama merged in 2000 implies not only the existence of insufficient integration but also the presence of strong relationships between clients and accountants in their operations, suggesting the possibility of insufficient systematization of the substance of organizational competence.

In terms of circumventing accounting fraud, Japanese audit firms are not always successful. The case of Misuzu Audit Corporation is typical. A more recent case of accounting fraud is that by Olympus Corporation in 2011, in which the major audit firms could not detect in advance the inappropriate internal procedures developed by executives. Altogether, 32 listed firms in Japan announced inappropriate accounting procedures in 2011 alone. We cannot attribute all the blame to a lack of organizational competence among Japanese audit firms, but their competence should be in question and examined further.

In the light of international competitiveness and the reliability of their audit services too, organizational competence in providing audit services by Japanese audit firms is in question. For example, international partners requested Japanese audit firms in March 1999 to include a sentence in the English-language versions of their financial statements stating that the audit reports employed Japanese standards and did not meet international standards. Historically, Japanese audit firms have made efforts to upgrade the quality of their audit services in cooperation with international partners by importing audit systems and procedures. However, their competence in doing so was not always highly appraised and was even called into question by their international partners.

5.3. Conclusion

In this paper, we examined the development process of organizing audit services in Japan as an historical example of the organization of professional services. The historical case suggested that scale expansion growth through merger promoted the organizing of professional services, while the case analysis clarified that three different rationales drove such growth, implying that Japanese audit firms succeeded in only establishing social proof of competence while substance of competence was in question. Insufficient integration or loosely coupled integration does not lead to the systematization of organizational competence. This then may be the most critical issue for professional service firms, given the fundamental tension between individuals and organizations. However, this is also applicable to other business firms. While merger can be the "easiest" way for a firm to grow, the process of post-merger integration remains a critical and ongoing issue for management.

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2011 Annual Report *(2011nen Nenji Hokoku Sho, in Japanese)*, Ernst & Young ShinNihon LLC.

Figure 1. Number of Audit Firms and Listed Client firms in Japan from 1967 to 2011

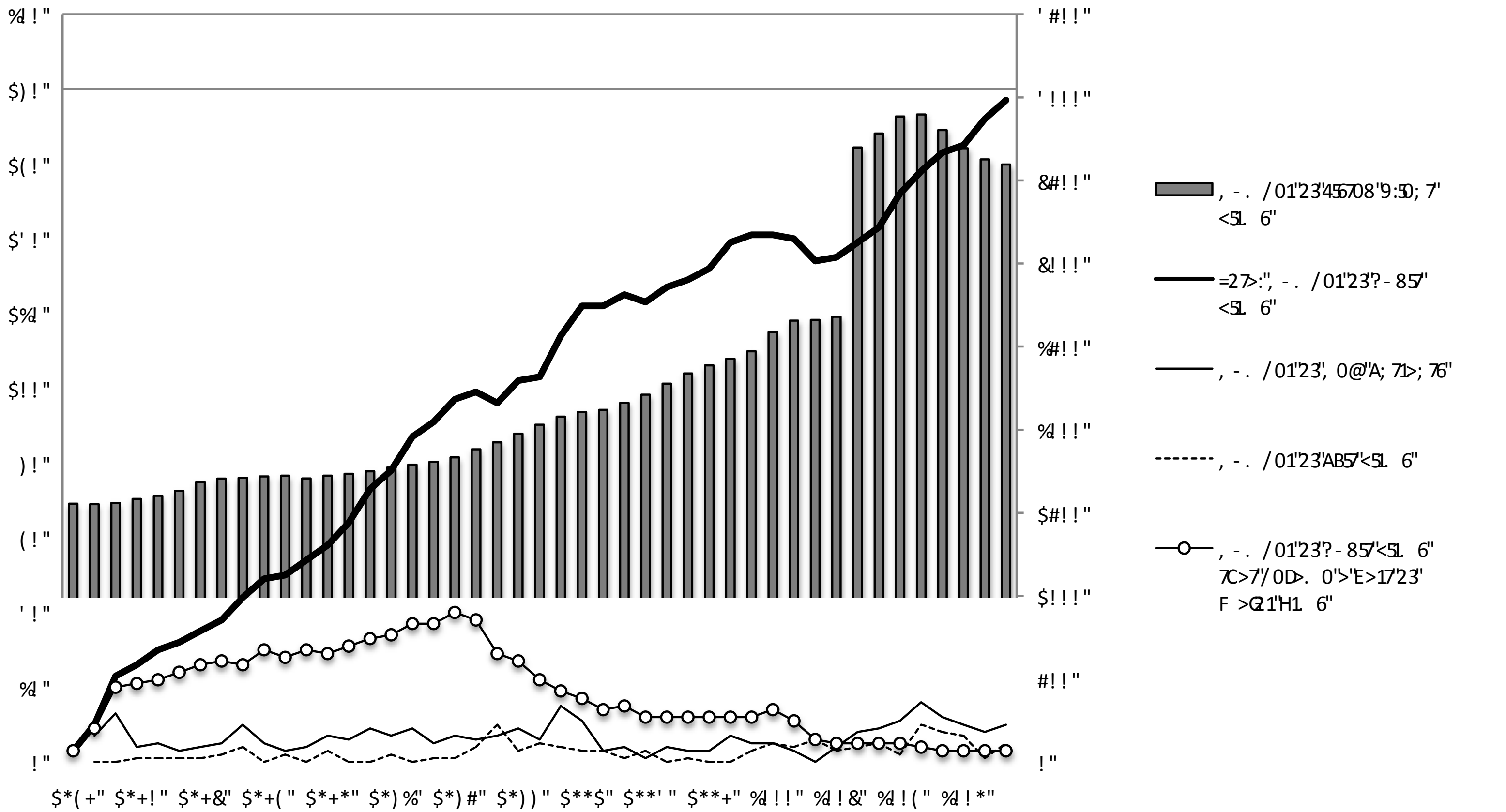


Table 1. Comparison of Market Share by Audit Firms

	As of March 31th, 1985(1806 listed firms)			As of March 31th, 2012 (3586 listed firms)		
	Name of Audit Firm	Number of Clients	Share(%)	Name of Audit Firm	Number of Clients	Share(%)
1	Chuo	179	9.91	ShinNihon	958	26.72
2	Asahi	172	9.52	Tohmatsu	905	25.24
3	Tohmatsu Awoki	120	6.64	Azsa	685	19.10
4	Showa	114	6.31	Arata	87	2.43
5	Ota	106	5.87	TaiyoASG	85	2.37
6	Shinko	89	4.93	Toyo	79	2.20
7	Shinwa	65	3.61	Sanyu	54	1.51
8	Daiichi	64	3.54	Kyoto	35	0.98
9	Sanwa Tokyo Marunc	38	2.1	Yusei	33	0.92
10	Nisshin	34	1.88	Gyosei	29	0.81
11	Marunouchi	34	1.88	Seiwa	27	0.75
12	Eiko	28	1.55	Osaka	22	0.61
13	Toyo	26	1.44	Kasumigaseki	20	0.56
14	Itoh	20	1.11	Nihonbashi	18	0.50
15	Musashi	19	1.05	Kazuhiro	16	0.45
16	Nihonbashi	19	1.05	Ark	15	0.42
17	Mizuho	17	0.94	A&A Partners	15	0.42
18	Aoyama	14	0.78	Asuka	14	0.39
19	Yaesu	13	0.72	Homori	12	0.33
20	Nishikata	12	0.66	Eisho	11	0.31

*Market share data in 1985 is based on Ozeki (1989:54).

** Market share data in 2012 is based on web page of JICPA.

Figure 2. Genealogy of ShinNihon Audit Corporation

Source: Annual Reports (*Ohkurasho Shoken Kyoku Nenpo, in Japanese*), Bureau of Securities, Ministry of Finance, Various Issues (1973, 1974, 1975, 1976, 1977,1978, 1979,1980, 1981, 1982, 1983, 1984, 1985, 1986, 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995). *25 Years History of Asahi Audit Corporation*, Asahi Audit Corporation, May 1996. *30 years History of Tohmatsu*, Tohmatsu Audit Corporation, March 2000. *History of Showa Ota*, Showa Ota Audit Corporation, March 2000. *25 Years History of Chuo Audit Corporation*, Chuo Audit Corporation, May 1994. Newspapers.

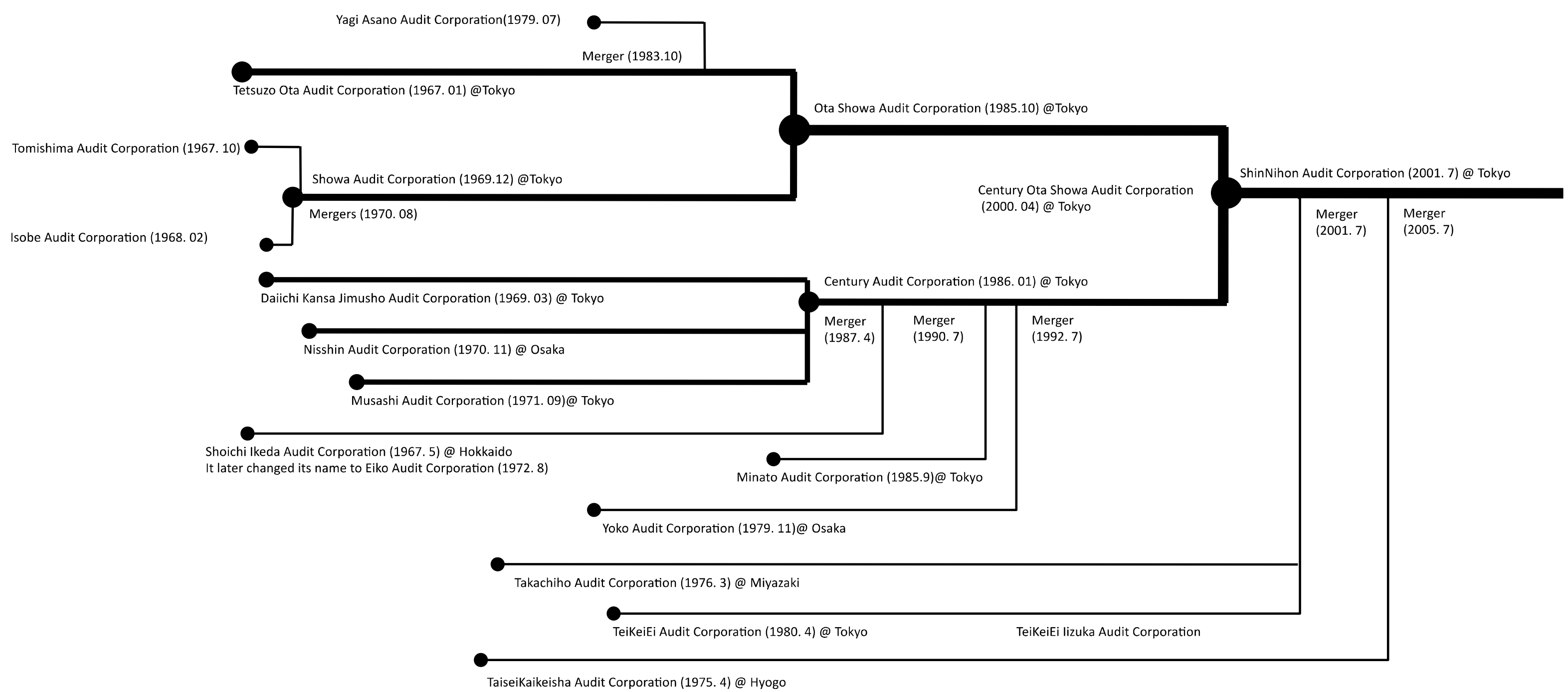


Figure 3. Genealogy of Thomatsu Audit Corporation

Source: Annual Reports (*Ohkurasho Shoken Kyoku Nenpo, in Japanese*), Bureau of Securities, Ministry of Finance, Various Issues (1973, 1974, 1975, 1976, 1977,1978, 1979,1980, 1981, 1982, 1983, 1984, 1985, 1986, 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995). *25 Years History of Asahi Audit Corporation*, Asahi Audit Corporation, May 1996. *30 years History of Tohmatsu*, Tohmatsu Audit Corporation, March 2000. *History of Showa Ota*, Showa Ota Audit Corporation, March 2000. *25 Years History of Chuo Audit Corporation*, Chuo Audit Corporation, May 1994. Newspapers.

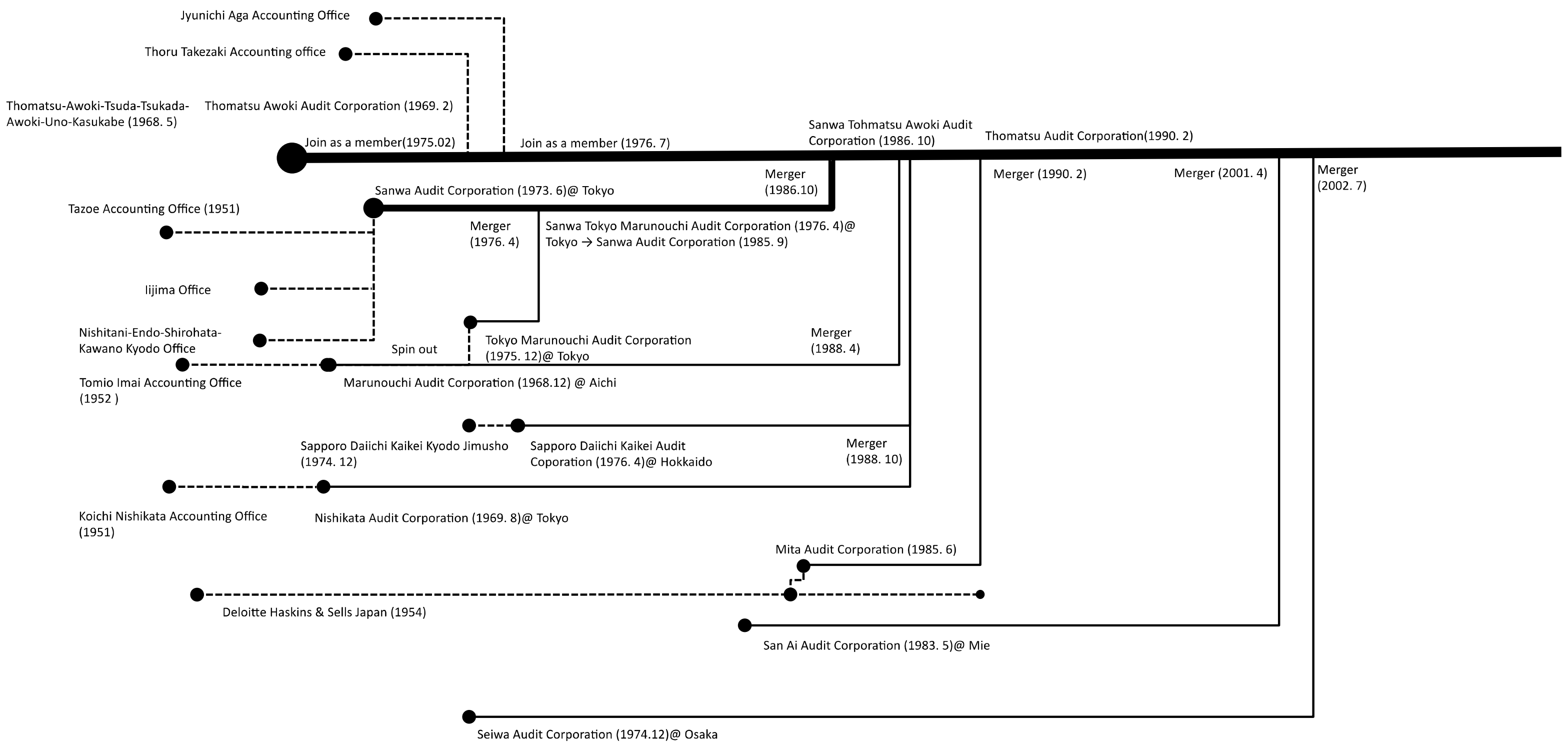


Figure 4. Genealogy of Azsa Audit Corporation

Source: Annual Reports (*Ohkurasho Shoken Kyoku Nenpo, in Japanese*), Bureau of Securities, Ministry of Finance, Various Issues (1973, 1974, 1975, 1976, 1977,1978, 1979,1980, 1981, 1982, 1983, 1984, 1985, 1986, 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995). *25 Years History of Asahi Audit Corporation*, Asahi Audit Corporation, May 1996. *30 years History of Tohmatsu*, Tohmatsu Audit Corporation, March 2000. *History of Showa Ota*, Showa Ota Audit Corporation, March 2000. *25 Years History of Chuo Audit Corporation*, Chuo Audit Corporation, May 1994. Newspapers.

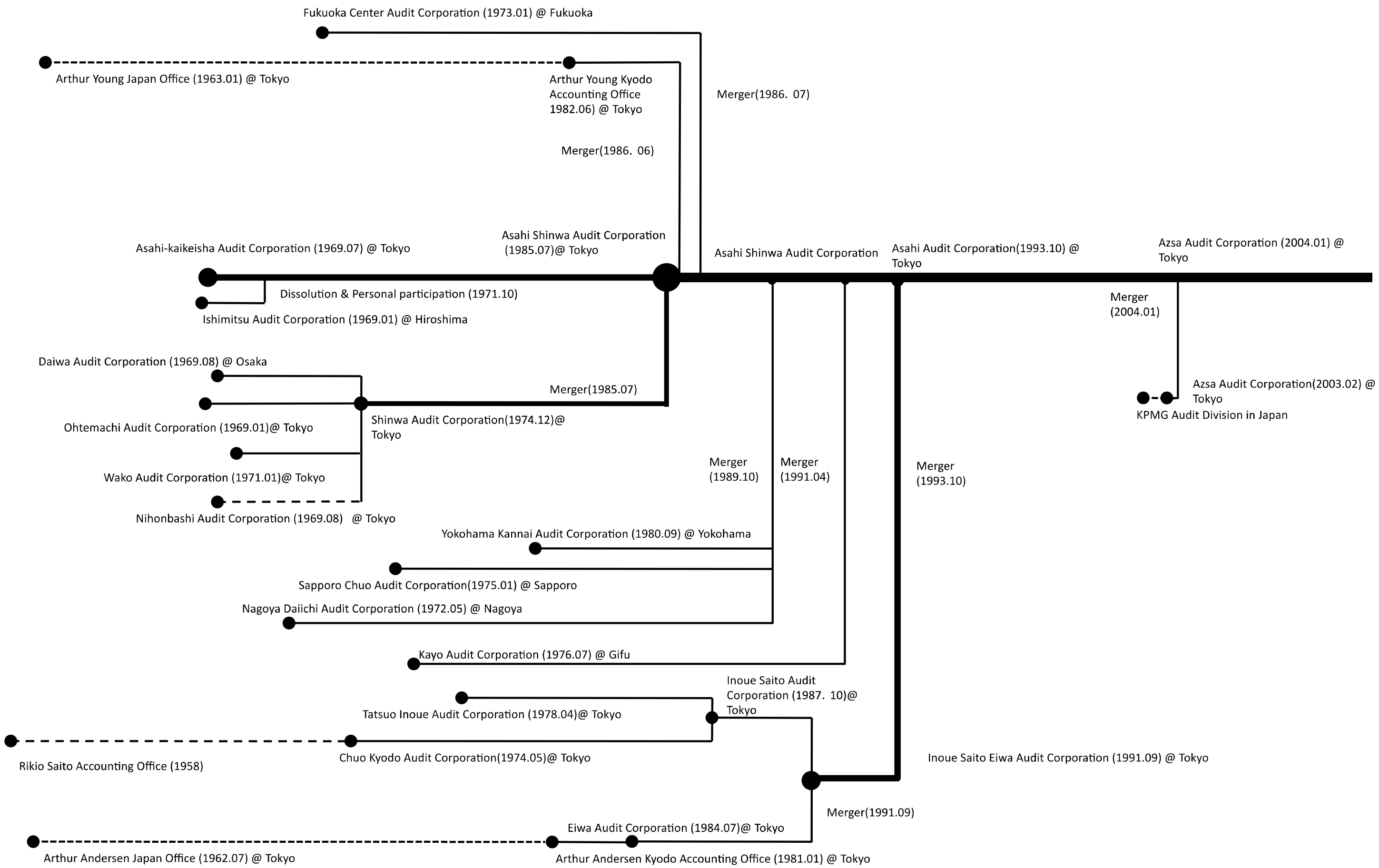


Figure 5. Genealogy of ChuoAoyama Audit Corporation

Source: Annual Reports (*Ohkurasho Shoken Kyoku Nenpo, in Japanese*), Bureau of Securities, Ministry of Finance, Various Issues (1973, 1974, 1975, 1976, 1977,1978, 1979,1980, 1981, 1982, 1983, 1984, 1985, 1986, 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995). *25 Years History of Asahi Audit Corporation*, Asahi Audit Corporation, May 1996. *30 years History of Tohmatsu*, Tohmatsu Audit Corporation, March 2000. *History of Showa Ota*, Showa Ota Audit Corporation, March 2000. *25 Years History of Chuo Audit Corporation*, Chuo Audit Corporation, May 1994. Newspapers.

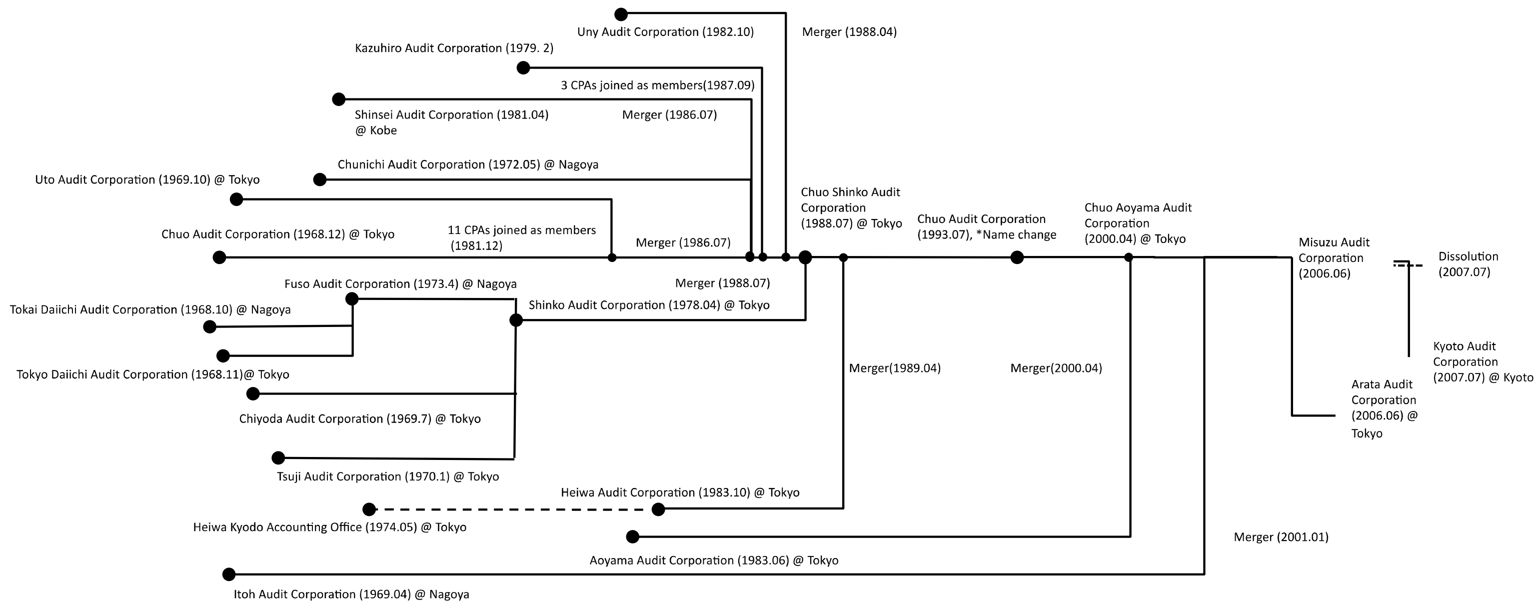


Table 2. Number of Client Firms per Accountant

Year	1—5 firms	6—10 firms	11-15 firms	16-20 firms	More than 21 firms
1959	349	55	4	3	3
1961	384	55	6	3	3
1962	491	68	10	3	4
1963	609	82	19	5	5
1964	648	94	18	6	7
1965	668	99	17	5	7

Unit: Number of CPAs

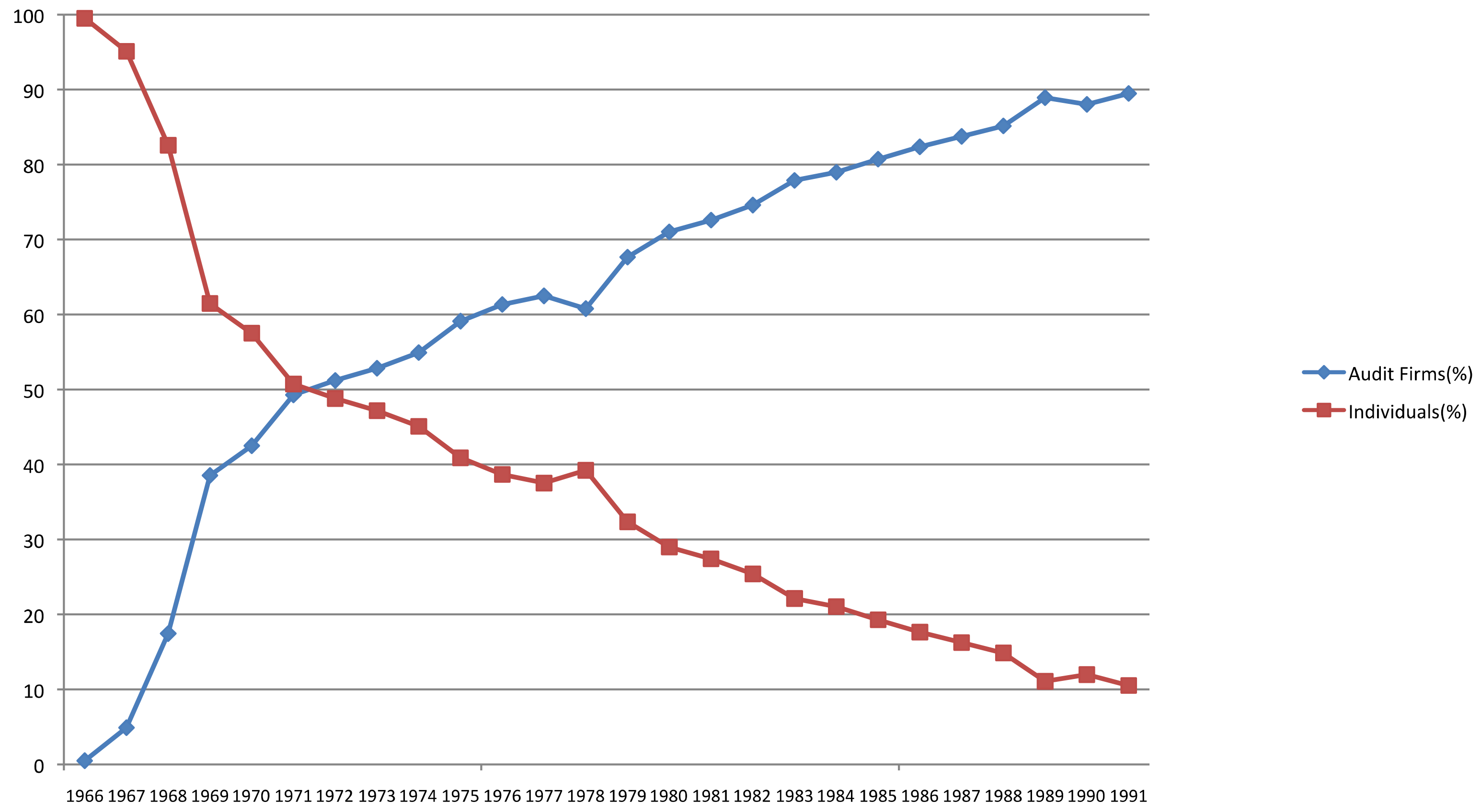
Source: *Accounting Fraud*, NihonKeizai Shinbun, 1966, pp.170.

Table 3. Single Contract and Joint Contract

Year	Single Contract (Number of Firms)	Joint Contract (Number of Firms)	Total
1959	1052	97	1149
1961	1140	102	1242
1962	1373	174	1547
1963	1712	251	1963
1964	1845	304	2149
1965	1893	330	2223

Source: *Accounting Fraud*, NihonKeizai Shinbun, 1966, pp.171.

Figure 6. Organizing Audit Services: Proportions of Individuals and Audit Firms



ENDNOTE

[1] This paper focuses on audit firms whose years of founding and dissolution are identifiable. As of March 2012, we thus identified 161 of the 213 audit firms registered by the Japanese Institute of Certified Public Accountants. As for the remaining 52 audit firms, we could not identify either their name or founding year.

[2] Formally, Ernst & Young ShinNihon LLC, KPMG AZSA LLC, and Deloitte Touche Tohmatsu LLC.

[3] *2011 Annual Report*, Ernst & Young ShinNihon LLC.

[4] *Tohmatsu Annual Review 2011*, Deloitte Touche Tohmatsu LLC. http://www.tohmatsu.com/view/ja_JP/jp/about/sh/index.htm.

[5] http://www.azsa.or.jp/profile/outline.html and *27th Annual Report,* KPMG AZSA LLC.

[6] Other examples of accounting fraud are Fuji Sharyo in June 1965, Osaka Doboku Kogyo in March 1966, Ohmi Kenshi Boseki in June 1967, SanWave in November 1967, Kurita-Kogyo in May 1968, Center Kogyo in October 1970, and Sankyo in April 1973 (*1973 Annual Report*. Securities Bureau, Ministry of Finance, p. 271).

[7] *1971 Annual Report*. Securities Bureau, Ministry of Finance, p. 262.

[8] An audit corporation is similar to a partnership in Western countries in that all partners bear the liabilities of the firm jointly and severally. At the time, the main requirements for an audit corporation to be established were as follows: (1) membership is limited to CPAs, (2) there must be at least five members, (3) all members must have the right and duty to participate in the practice, (4) no member is to be under suspension from practice or to have contravened provisions of the law, and (5) the corporation must have sufficient organization, personnel, and facilities to ensure the adequate conduct of the practice.

[9] At the time of its inception, the firm had more than 20 client firms (*History of Showa Ota,* p. 46).

[10] *30 Years History of Tohmatsu*, p. 40.

[11] *25 Years History of Chuo Audit Corporation,* p. 26 and *Nihon Keizai Shinbun* (November 12, 1968). Major large listed firms included Yahata Seitetsusho, Fuji Seitetsu, Mitsubishi Heavy Industry, Asahi Glass Company, Maruzen Petroleum, Nihon Yusen, Kanebo, and Shimizu Construction.

[12] *25 Years History of Asahi Audit Corporation* p. 27.

[13] *25 Years History of Asahi Audit Corporation* pp. 36–37.

[14] *History of Showa Ota,* p. 165.

[15] *30 Years History of Tohmatsu,* p. 147.

[16] *25 Years History of Asahi Audit Corporation,* p. 136.

[17] *25 Years History of Asahi Audit Corporation,* pp. 134–135.

[18] *30 Years History of Tohmatsu,* p. 140.

[19] *30 Years History of Tohmatsu,* p. 153.

[20] *25 Years History of Chuo Audit Corporation,* p. 67.

[21] *History of Showa Ota,* pp. 102–103.

[22] *30 Years History of Tohmatsu,* pp. 77–78.

[23] *Nihon Keizai Shinbun* (November 15, 1984).
[24] *25 Years History of Asahi Audit Corporation*, p. 148.
[25] Declined by the Ministry of Finance for reasons of market dominance (*30 Years History of Tohmatsu*, pp. 243–244).
[26] *History of Showa Ota*, p. 124.
[27] *Kigyo Kaikei*, vol. 27 no. 7, 1975, pp. 985–987.
[28] *Nihon Keizai Shinbun* (October 9, 1985).
[29] *25 Years History of Chuo Audit Corporation*, p. 94.
[30] *30 Years History of Tohmatsu*, p. 236.
[31] *30 Years History of Tohmatsu*, p. 266.
[32] *25 Years History of Asahi Audit Corporation*, pp. 277–278.
[33] *25 Years History of Asahi Audit Corporation*, pp. 270–271.
[34] *Nihon Keizai Shinbun* (November 25, 1999).
[35] Another example was the merger between Chuo Shinko Audit Corporation and Heiwa Audit Corporation in October 1989.
[36] *Nihon Keizai Shinbun* (May 12, 1992).
[37] *Nihon Kogyo Shinbun* (September 16, 1985) and *Nihon Keizai Shinbun* (September 14, 1999).
[38] *Nihon Keizai Shinbun* (April 1, 2000).
[39] *History of Showa Ota*, pp. 51–52.
[40] *25 Years History of Chuo Audit Corporation*, pp. 36–39.
[41] *25 Years History of Asahi Audit Corporation*, pp. 53–56.
[42] *25 Years History of Asahi Audit Corporation*, p. 177.
[43] *30 Years History of Tohmatsu*, p. 205.
[44] *30 Years History of Tohmatsu*, pp. 194–195.
[45] *30 Years History of Tohmatsu*, p. 189.
[46] *30 Years History of Tohmatsu*, p. 199.
[47] *30 Years History of Tohmatsu*, p. 177.
[48] *Nihon Keizai Shinbun* (September 2, 1986).
[49] *Nihon Keizai Shinbun* (May 12, 1992).
[50] For example, Nikko Cordial Securities and Sanyo Electric.
[51] *History of Showa Ota*, p. 215.
[52] *History of Showa Ota*, p. 215.
[53] *25 Years History of Asahi Audit Corporation* pp. 36–43.
[54] *25 Years History of Asahi Audit Corporation* pp. 44–49.
[55] *Nihon Keizai Shinbun* (December 17, 1999).