

# Governmental Audit and Administrative Evaluation : From Auditing Perspective

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## 1. Foreword

Following the 2001 state reorganization of ministries and agencies, steps were taken to introduce an administrative evaluation system for the national administration in Japan. Concrete studies are to be conducted on its theories and techniques in the future, and this will present a new field of research in Japan. In light of this, this paper presents a challenging review of administrative evaluation, its relation to governmental audits and the roles that it should take, from auditing perspective.

## 2. Governmental Audit and Auditing

“Exactly what is an audit?” Surprisingly, there is no uniform reply to the question. For example, one interpretation is that an audit is something related to accounting and that the theory of auditing is simply a branch of accounting. The U.S. scholar of accounting, Littleton [1953], positioned auditing within the accounting process. Namely, he could not imagine any type of accounting that did not involve audit functions.<sup>1)</sup>

On the other hand, there is also the idea that auditing is, as it were, a widespread activity that checks on things and that accounting-related auditing is no more than the activity of checking. For example, U.S. scholars of audit theory Mautz and Sharaf [1961] argued, “It is quite incorrect to consider auditing to be a subdivision of accounting. Auditing is concerned with accounting, which explains why auditors are accountants first, but it is not a part of accounting.”<sup>2)</sup>

Thus, from an academic point of view, it appears that audit theory has not been well-defined in its coverage. In this respect, even if based on the views of Mautz and Sharaf, there is no doubt that the typical auditing activity is related to accounting, both quantitatively and qualitatively. In other words, the act of accounting-related auditing typifies the act of auditing. This explains the fact that the majority of audit researchers are also researchers of accounting, and substantiates the rationality of researching audit theory from the standpoint of accounting.

Though we acquire legitimacy in the study of auditing chiefly from the standpoint of accounting, Japanese person often face the question whether a governmental audit constitute an audit or not.

The Japanese word “*kansa*” has been translated into “audit” and “auditing” in English, which etymologically derives from sources similar to “audio,” for example, namely, from words meaning “listening” and “listening and dictating.” There are different opinions on the reason why the English word “audit” was translated into the Japanese word “*kansa*.”

On the other hand, the word “audit” is also translated into the Japanese word “*kensa*” . Needless to say, the

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1) Littleton [1953], Chapter 6.

2) Mautz and Sharaf [1961] pp.13–14.

Board of Audit , Japan applies “audit” to “*kensa*.” Accordingly, in terms of English expression, there is no distinction made between “*kensa*” (governmental audit) and “*kansa*” (audit) in Japanese texts. As far as social practices in foreign countries are concerned, no strict conceptual distinction has been made between auditing in the public and private sectors, despite the differences in wording. Accordingly, it would make little sense to pursue differences in concept between “governmental audit” and “audit.” I dare say that, generally speaking, “*kaikai kensa*” (governmental audit) refers to auditing in the public sector, while “*kaikai kansa*” (audit) refers to auditing in the private sector. This paper thus proceeds with a discussion of the main theme based on the definition that an governmental audit is one form of auditing.

### 3. Auditing in the Private Sector

The most common form of audit should be that carried out by certified public accountants (CPAs). In Japan, the CPA audit system was introduced after the World War II and was originally designed for private sector. Perhaps because of such background, the word “*kansa*” invariably reminds us of “auditing private enterprises” in Japan. In fact, most colleges generally focus their auditing lectures on private sector. It would not be exaggerating to say that, as a result, college students rarely have the opportunity to study the public sector auditing. This also holds true for accounting as a whole. In other words, opportunities for learning about public sector accounting are unexpectedly rare in Japanese educational institutions. Moreover, public sector accounting and auditing have never been very active in the spheres of education or research.

This may appear as natural, since Japan is a capitalistic nation based on free economy. Compared to other major capitalistic nations of the world, however, it appears that education and research concerning public sector accounting and auditing has been neglected in Japan.

Of course, research into accounting and auditing practices in the public sector should not be carried out on its own, but should necessarily be carried out by considering the similarities and differences in regard to accounting and auditing in the private sector. In Japan, however, it is doubted that studies have been conducted on public sector accounting and auditing bearing in mind their counterparts in the private sector.

For instance, we can see a conceptual distinction between accounting audits and operational audits in the private sector. Accounting audits are generally focused on financial information such as financial statements, while operational audits are directed towards business operations. Commonly, CPAs are committed only to accounting audits, while Corporate Auditors in Japanese Commercial Law (CAs) are committed to both accounting and operational audits. In corporations audited by CPAs, however, CAs are considered to largely base their opinions on the audit results of CPAs. This reflects the current trend that accounting audits are being entrusted to accounting specialists as private enterprises scale up in structure and operation. More specifically, an effective accounting audit is becoming difficult except when done by accounting experts.

On the other hand, operational audits conducted by CAs may be classified as audits of directors in the execution of their duties and responsibilities, and as an audit of personnel other than directors in the management of overall corporate operations. The internal audit division is normally responsible for the latter function in major corporations, with CAs making use of its findings.

Though falsely similar to the classification of accounting audits and operational audits, recent discussions often compare information audits and factual audits. As mentioned above, conventional accounting audits are directed towards financial information. This is considered as an information audit which is directed toward accounting information. On the other hand, a number of corporate fraud cases have recently been raising social concerns, and corporations are being urged to reinforce their auditing functions in order to detect and prevent such malpractice. In this instance, in order to meet social expectations, it is unsatisfactory if accounting audits remain within the conventional coverage of information auditing. In other words, it is also necessary to audit the actual business transactions and activities on which the accounting records were based. Such auditing is termed “factual auditing.” Though factual auditing does not equal to operational auditing, there is a likelihood that application of accounting audits will be extended to transactions and activities, to which only operational audits were applied in the past. Specifically, it is only after complementary and integrated information and factual audits have been made that

effective accounting audits can be performed.

Let us look at the current status of public auditing, especially at the national level in Japan, with reference to our previous discussion of the private sector auditing concepts.

In this context, the function of accounting audits has been carried out by the Board of Audit in Japan as governmental audit, while the function of operational audits has been performed by the former Administrative Inspection Bureau of the Management and Coordination Agency as an administrative inspection (prior to the 2001 state reorganization). Now that there are social demands that private sector audits also be applied to the public sector, both information audits and factual audits should accompany governmental audits. In other words, it will be likely that governmental audits are required to undertake functions usually performed by administrative inspections.

Table 1 Accounting Audits and Operational Audits

	Conventional	Modern
Accounting audits (governmental audit)	Mainly, information audit	Information audit + factual audit
Operational audits (Administrative inspection)	Mainly, factual audit	Mainly, factual audit

#### 4. Introduction of Private Sector Accounting and Auditing Practices

The application of private sector accounting and auditing systems and practices to the public sector is common in developed countries, which is not always the case in Japan.

Recently, however, such an approach is also beginning to prevail in Japan, as typified by the introduction of balance sheets in public sector.

In Japan, Kumamoto Prefecture pioneered the introduction of balance sheets in its accounting in 1987.<sup>3)</sup> This trial temporarily lost momentum and failed to spread to other prefectures, but was later spotlighted again when local governments faced the post-bubble financial crisis in Japan, as heralded by the balance sheet disclosed by Usuki City of Oita Prefecture in 1998.<sup>4)</sup> Thereafter, the preparation of balance sheets prevailed among local autonomies with a renewed vigor, and it was also discussed at the central government level.

It should be noted in this connection, however, that balance sheets prepared by private enterprises are based on double-entry bookkeeping, whereas counterparts in the public sector are merely based on the single-entry bookkeeping system. Japanese public sector accounting is conventionally based on the cash basis accounting with the single-entry bookkeeping system. This remains unchanged, even following the introduction of the balance sheet. Under the double-entry bookkeeping system, balance sheets and income statements can be generated automatically. On the other hand, in the public sector, balance sheets are now prepared simply by arranging accounting data derived from single-entry record and presenting them in a way that resembles their private sector counterparts.

In this sense, straightforward comparison of balance sheets prepared by public and private sectors in Japan is not rational. Furthermore, the way accounting data is arranged varies between local governments. As a result, in current Japanese status, it is difficult to compare balance sheets between local governments based on common criteria. To solve this problem, it should be introduced double-entry bookkeeping in the public sector to pave the way for automatic generation of balance sheets, and to utilize them as accounting systems for information disclosure and operational management in the same manner as in the private sector.

The reason why the private sector uses double-entry bookkeeping, however, is that it provides them with an effective means to find profits, the final purpose of private business. Both balance sheets and income statements prepared by double-entry bookkeeping have a characteristic of the statement of profit measurement. On the other

3) Tatsuzo Sato, "Fiscal Management of Kumamoto Prefecture using Balance Sheets (School of Economy)", *Nihon Keizai Shimbun*, December 4, 1987, Morning Edition.

4) Ishiwara [1999], Chapter 6.

hand, it might be logical to claim that public institutions need no such double-entry bookkeeping because they are non-profit organizations. That is why there is no active move towards the introduction of the double-entry bookkeeping system and income statements, in spite of the fact that pressure for the introduction of balance sheets in the public sector is increasing.<sup>5)</sup> In other words, balance sheets are prepared by public institutions, but their purposes differ greatly from those of private enterprises.

At present, controversies among accounting specialists in the public sectors in the world are focused on the introduction of double-entry bookkeeping and accrual-based accounting systems. Also in Japan, for instance, Mie Prefecture is known for its aggressive challenge to the introduction of the accrual basis accounting system.<sup>6)</sup> The absence of double-entry bookkeeping practices can invalidate the effect of introducing accrual-based accounting. An annual budgeting system can also be a barrier to accrual-based accounting, in which the time at which cash is paid out is not defined as the time at which the expense was accrued.

Furthermore, the fact that Japanese public institutions do not have fund operation divisions can indirectly affect present accounting practices. Fund operation divisions usually invest into financial products to earn profit if there is a surplus of annual budget instead of using it in a fiscal year. Earned profits are, of course, deferred to subsequent fiscal years. If public organizations depend solely on tax revenue for fiscal expenditures under the annual budgeting system, expenditures can increase in a thriving economy or decrease in a depressed economy, inasmuch as tax revenues depend on the prevailing economy. Since people seek more public expenditures to survive recession, public organizations inevitably resort to bond flotation to cover fiscal deficits. On the other hand, if public organizations can profitably operate their surplus funds in a thriving economy, they can keep the earnings as a contingency reserve or for tax cuts, as required.

If public organizations operate on such a "profit-earning" system, in which profits earned are transferred to the general account budget, it will be necessary for their accounting systems to operate on principles applicable to private enterprises, including the introduction of double-entry bookkeeping and accrual-based accounting.

Japanese public institutions are basically motivated to adopt the practices of private sector accounting, but they seem to find it unnecessary to adopt them in their entirety, since Japanese accounting systems in the public sector remain little changed.

## **5. VFM (Value for Money) Auditing, Governmental Audits, and Administrative Inspections**

Ordinarily, in Western countries, accounting profession engage in auditing public institutions in some way or other. Needless to say, CPAs represent accounting profession in Japan. In the case of Japan, however, public sector auditing by accounting profession did not really exist until it became feasible to employ CPAs as external auditors for local governments auditing. This followed the introduction of the external audit system by prefectural and major cities' governments, upon the recent revision of the Local Autonomy Law.

Public sector auditing by accounting profession looks, at a glance, like the introduction of the private sector audit system to the public sector, but this interpretation is not always accurate. Looking back on the history of accounting profession, we find that they actually originate from public sector auditing. For instance, they emerged in cities in Britain during the 14th to 16th centuries, when outsiders and civic representatives began to audit municipal organizations, etc.<sup>7)</sup> Importantly, here lies the origin of the social need for auditing. Later, during and after the 17th and 18th centuries, the practice of accounting profession spread throughout the private sector, which had matured in the course of the Industrial Revolution. It would thus be reasonable to say that accounting profession originated from public sector auditing. Therefore, it can never be said that it is strange for outsiders, including CPAs and other accounting profession, to audit public institutions.

Nevertheless, since public institutions and private enterprises operate for different purposes, they necessarily employ different techniques. Appropriate methods should be introduced into the present-day public institutions to

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5) In Japan, some of public sector organizations also have tried to prepare income statements or corresponding accounting statements, but it seems that the private sector makes more of income statements, while the public sector mainly directs its attention towards balance sheets.

6) Ishiware [1999], Chapter 5.

7) Littleton [1933], Chapter 16

accomplish their aims.

A typified example is called VFM auditing or 3E auditing. As is well known, auditing is performed based on the three major yardsticks (Merkmal) of efficiency, economy, and effectiveness (the 3Es). These techniques originate from the United States and were further developed in the United Kingdom.

Accounting specialists must be familiar with these techniques in order to perform successful audits on public institutions. In this respect, since Japanese accounting specialists have just begun to audit public institutions, they must accumulate their practical experiences in this field although they are well aware of the problems. I would like to point out that it was the Board of Audit that pioneered recognition of the importance of VFM auditing and planning of its implementation in Japan.

Though the importance of VFM auditing in the public sector has also been admitted in Japan, what is often raised as a problem is that VFM auditing involves substantial elements that are indeterminable by quantitative standards alone. Especially, it was pointed out, for effectiveness audits. This is because governmental audits involve something similar to a factual audit. In other words, the attempt to include VFM auditing in an governmental audit is nothing other than the inclusion of elements of factual auditing. Accordingly, the fact that VFM audits are conducted in the process of governmental audits in Japan is based on this background.

Paradoxically, the need for VFM auditing definitely lies in the requirement for administrative inspections. Ordinarily, audits involving physical audit-like elements have been performed upon operational audits, mainly through administrative inspections. In summary, from the viewpoint of VFM auditing, governmental audits and administrative inspections partially overlap.

To date in Japan, however, it is rare that administrative inspections are discussed from such a viewpoint. I think that it has been common in Japan that they had been discussed from the administrative rather than from the audit theory viewpoint. When considering effective auditing as a whole, I believe it is necessary to consolidate governmental audits and administrative inspections from the viewpoint of audit theory.

## 6. Experiences in Hokkaido and Policy/Administration Evaluation

Following the state reorganization of ministries and agencies, the Administration Inspection Bureau of the Management Coordination Agency, which was responsible for administrative inspection, was reorganized into the Administrative Evaluation Bureau of the Ministry of Public Management, Home Affairs, Posts and Telecommunications, which is responsible for administrative evaluation. As described later, a policy evaluation system was newly introduced as a part of administrative evaluation.

The introduction of policy evaluation systems is common in foreign countries, but how to successfully implement such evaluations undoubtedly remains a difficult issue throughout the world.<sup>8)</sup> In this sense, the introduction of a policy evaluation system in Japan was most timely. Now, when looking back on the process of introducing the policy evaluation system in Japan, we may conclude that we encountered a very meaningful experience in Hokkaido Prefecture. The local government of Hokkaido has been urged to reassess its state accounting and audit systems in light of a series of accounting misdemeanors by officers, concerning mutual entertainment on expense accounts between civil service personnel and the fabrication of statements for official trips.<sup>9)</sup> These issues later spread to other prefectures and led to the introduction of external auditing systems following revision of the Local Autonomy Law.

Later, the need for further reform in Hokkaido Prefecture was demanded and, as a result, the introduction of an “overdue -project assessment ” program committed to the inspection of long outstanding projects after they had been approved and budgeted over the past years. In 1997, this program pointed out that six projects should be reassessed regarding their continuance, with the program attracting widespread attention among central and local governments.

Additionally, an annual “policy assessment” was introduced in fiscal 1997. The introduction of the “overdue-

8) Christensen and Yoshimi [2000] conducted comparative studies on the process of introducing policy assessment programs in Hokkaido Prefecture and New South Wales, Australia.

9) Yoshimi [1997], Yoshimi [1999] Chapter 18, and Yoshimi [2000].

project assessment” program thus caused a breakthrough in the introduction of the policy evaluation system in Hokkaido Prefecture.<sup>10)</sup> Such evaluations then spread rapidly to other local governments,<sup>11)</sup> becoming known as “policy evaluations” or “administrative evaluations.”<sup>12)</sup>

Policy evaluations were conducted in Hokkaido Prefecture in two ways: one was a clerical service evaluation by budget classification; the other was a policy evaluation designed to determine the levels of targets achieved. The evaluation was conducted within prefectural bureaus and departments. In fiscal 1999, 2,801 projects were inspected and, among them, 182 projects were subjected to further re-evaluation, and 33 projects were either suspended or scrapped.

With respect to policy and administration evaluation, Japanese local governments cover a fairly wide range of activities, but have not yet to reach a level where methods for quantitative evaluation standards can be easily identified. This is understandable, because only several years have elapsed since attention was first paid to policy and administration evaluation systems.

Likewise, the central government also began to tackle the issue of policy and administration evaluation. In July 2000, “a proposal for Standard Guidelines for Policy Evaluation” was made public by the secretariat of the Central Government Reorganization Headquarters and Administrative Inspection Bureau of the Management and Coordination Agency. It was decided that, under the proposed guidelines, policy evaluations should be introduced following the 2001 state reorganization, including ministries and agencies.

According to the guidelines, each central government ministry and agencies should conduct a policy evaluation of their own. In addition, the Ministry of Public Management, Home Affairs, Posts and Telecommunications will conduct an evaluation of the policies of ministries and agencies as an organization exclusively responsible for evaluation. Evaluation will be appropriately based on three methods, including

- a) project evaluation that assesses clerical services before, during, and after implementation thereof;
- b) performance evaluation that determines the level of administrative targets achieved;
- c) comprehensive evaluation that assesses specific themes assigned from an overall viewpoint.

Specifically, project and performance evaluation can be basically deemed to be identical to the policy evaluation implemented by Hokkaido Prefecture, whereas comprehensive evaluation, which is conducted upon the lapse of a specified period of time from the introduction of particular policies and measures and may lead to reviewing the policies or the measures, is deemed to correspond to the “overdue-project assessment” system.

Factors concerning needs, efficiency, effectiveness, equity, and priority constitute the standards of policy evaluation. Clearly, these standards overlap VFM-based standards.<sup>13)</sup> VFM audit standards for assessment of economy, efficiency, and effectiveness can be quantified in many cases, but there are also cases where quantification is difficult or inappropriate. It is necessary to conduct further research, keeping public audit techniques for policy evaluation in mind.

Conventional administrative inspections play a role as an internal audit when looking on whole administrative organizations as one, which leads us to assume that they perform the function of operational audits. This holds true with administration evaluations by the Administrative Evaluation Bureau of the Ministry of Public Management, Home Affairs, Posts and Telecommunications. In addition, policy evaluation should basically be carried out by each ministry or agency. Consequently, the introduction of a policy evaluation system is looked upon as establishing new roles like internal audits, when each ministry or agency is regarded as a separate individual organization.

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10) Yamaguchi [1999], p.66.

11) According to a survey of the Ministry of Home Affairs, the policy evaluation system was either in full or trial operation in 26 prefectures by September 1999. (Source: Hokkaido Shimbun, December 29, 1999, Morning Edition)

12) Normally, policy evaluation is strictly distinguished from administrative evaluation as they involve different concepts. It appears, however, that they have not been clearly distinguished in Japan, especially with respect to practices in local governments (Yamaya [1998], p.52 and p.62).

In view of the current situation, this paper presents these forms of evaluation without making any particular conceptual distinction. The paper, however, treats state-level policy and administration evaluations as involving different concepts (See Note 14).

13) Takayori [2000] refers to the clarification of the 3E principles and the concept of its public usage as targets of the administrative evaluation system (Takayori [2000], p.55).

## 7. Conclusion

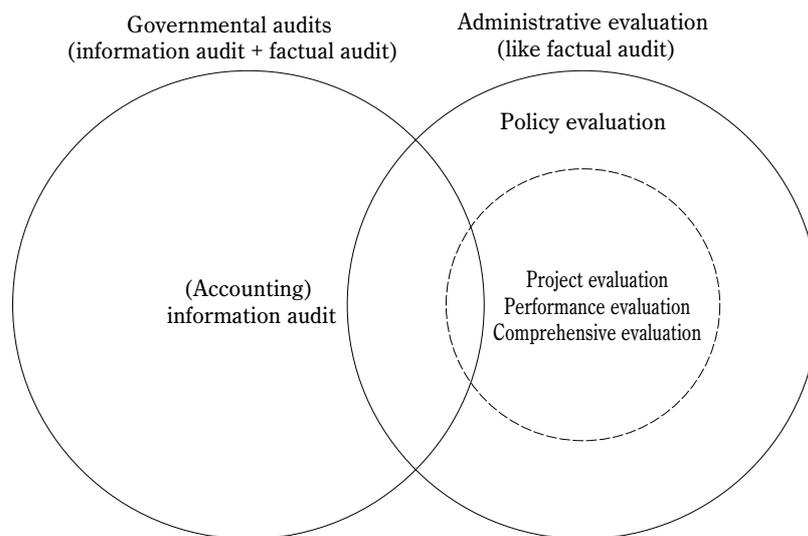
Policy assessment will be conducted as a part of administrative assessment by the Administrative Evaluation Bureau of the Ministry of Public Management, Home Affairs, Posts and Telecommunications. Fundamentally, conventional administrative inspections did not take an active stance towards referring to the effects or results of the policies themselves. On the other hand, the VFM auditing concept necessarily involves policy evaluations. It seems that herein lies the dilemma of administrative inspections that include the VFM auditing concept. However, the newly introduced policy evaluation system is obviously designed to assess policy itself. Taking this into account, the new system will be characterized by administrative evaluation, which includes the evaluation of the results of policies covered by conventional administrative inspections.<sup>14)</sup>

Discussions and studies on such policy or administrative evaluations are, in most cases, conducted from the viewpoint of public administration. It appears that fewer studies are made from the viewpoint of audit theory or in relation to governmental audits.

In view of the current developments in accounting audits, it would be difficult to hope for up-to-date, effective auditing unless concepts of factual auditing are introduced. Also, the importance of the VFM concept has been recognized and it is now in practice in accounting audits in the public sector. In this respect, accounting audits and administrative evaluations are closely interrelated. This implies that it is essential to introduce factual audit functions, namely, administrative evaluations, into governmental audits.

It is also necessary, as a matter of course, to examine administrative evaluations from an audit theory viewpoint, as discussed in this paper. It is important to conduct consistent studies on governmental audits and administrative evaluations from the viewpoint of audit theory and unite these approaches.<sup>15)</sup> It is certain that the audit function of administrative organizations as a whole can only be performed effectively after such integration has been achieved.

Figure 1 Governmental Audits and Administrative Evaluations



With respect to governmental audits, it is necessary to further upgrade and reinforce public sector auditing techniques, such as VFM auditing, and to meet the specific and widening needs of private sector auditing. For

14) Such an interpretation matches the practices in policy and administrative evaluation systems now introduced into Japan. (Higashida [1999] pp.5-6). It does not provide elucidation of the logical relationship between policy evaluation and administrative evaluation.

15) As shown in this paper, the word "integration" in this paragraph does not mean the integration or unification of organizations into a single unit. It is necessary that internal audit-like administrative evaluations and external audit-like accounting inspections are allowed to coexist. If they remain unrelated, however, they lose much of their audit function. For example, it is necessary to establish a relationship in which the results of administrative evaluations are utilized within governmental audits, in much the same way as CPAs and auditors utilize the results of the internal audit division of private enterprises.

example, an increase in independent administrative institutions could expedite the introduction of accounting concepts in the private sector, and also the preparation of balance sheets, the introduction of accrual-based accounting and double-entry bookkeeping practices, etc.

Amid such moves, it will be essential to consider the relationship of such methods with CPA audits that are conventionally suited to the private sector. As mentioned, it is not strange at all for accounting profession such as certified public accountants to engage in public sector auditing. Particularly, there will be an increasing trend that more accounting profession will be required for field audit practice, which demands the special skills and expertise of professionals. Opportunities are also increasing in Japan, though still relatively limited, for external auditors to engage in public sector audits, such as for local governments. It is expected that this trend will steadily increase.

Also with respect to auditing the central government, the need to reassess its audit practices in conjunction with the CPA system may emerge. *Governmental audits* constitutes auditing, where a high level of expertise is required. Public sector auditing should be appropriate for accounting specialists who engage in auditing as a profession. In this context, it would be resourceful to employ CPAs or junior CPAs as public audit inspectors in the future. On the other hand, peculiar auditing concepts as represented by the VFM formula, etc. are required for public sector auditing. In other words, it would be absurd to assume that we can perform the entire range of functions required in a public sector audit merely because we have some experiences in private sector auditing.

In this sense, the Board of Audit, Japan has been engaged in governmental audits on the strength of its high level of expertise. Definitely, the Board of Audit represents a group of the most advanced accounting specialists in public sector auditing. It may be realistic to assume that they should be qualified as CPAs based on the condition that they have completed a specific course of governmental audits and practical experience. At any rate, it is preferable that accounting specialists engage in accounting audits, regardless of whether it is public or private sector auditing. To achieve this end, there is a need for accounting specialists who can cope with administrative evaluations, including physical auditing utilizing the VFM formula, as a means of ensuring that up-to-date public sector auditing is feasible.

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